VIRGINIA ON BRINK OF CALIFORNIA-STYLE CRISIS 4-5
SCHWARZENEGGER CAVES ON SPENDING LIMIT 9
TABOR 10-11

Budget&Tax News

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Growing Economy Aids State Budgets

by Chris Atkins

Year-end 2003 economic reports suggested the U.S. economy is on the road to recovery.

"After two years of poor resolution, the economic landscape is coming into focus," said Duncan Meldrum, president of the National Association for Business Economics (NABE) and chief economist for Air Products & Chemicals, Inc. "We see a stronger expansion developing [in 2004], one that should be sufficient to gradually put idle resources, both workers and factories, back to work."

Meldrum added in a December 2003 news release highlighting NABE's projections, "The [economic] panel's expectations for GDP growth in 2004 was upgraded moderately from when we last surveyed the group in September. Our forecasters now project an average GDP gain of 4.5 percent for 2004." Such an increase is "above average" and the best of the emerging decade to date.

"The reports of the demise of the United States economy are greatly exaggerated—especially by Democratic Presidential candidates," noted a recent American Legislative Exchange Council (ALEC) report. "Current economic indicators are great. Especially in the third quarter of 2003: GDP growth of 8.3 percent, corporate profit increase of 11.8 percent, decrease in the unemployment rate, a 2.4 percent increase in produc-

GROWING p. 17

ATR Ranks Dean a "Tax and Spend" Governor

During his tenure as Governor of Vermont, Democratic Presidential candidate Howard Dean "did not demonstrate convincingly that he cared one way or the other about taxpayers," according to Grover Norquist of Americans for Tax Reform.

Agence France Presse

by Emily Sedgwick Ansell

Democratic Presidential hopeful Howard Dean ended 2003 on the campaign trail, defending his record as governor of Vermont.

But according to Americans for Tax Reform (ATR), Dean's record on taxes cannot be defended. During the nearly 12 years of his governorship, property taxes to fund schools almost doubled, while taxes to pay for municipal government increased by an average of 56 percent.

"This is particularly interesting given that the consumer price index—a pretty good indicator of inflation—increased by just 38 percent during that period," commented Grover Norquist, president of the taxpayer advocacy group.

"It really begs the question: What was going on in Montpelier and across Vermont from 1990 through 2002? What does Dean's record as governor indicate about his plans for the country?" asked Norquist.

According to Norquist, whose Washington, DC-based organization ranks governors on a scale of 1 (best) to 3 (worst) for their efforts to defend taxpayers against tax increases, Dean's tenure as governor demonstrates a

DEAN p. 7

California Launches New Round of Workers' Compensation Reform

by Susan Martin

In early January, California Governor Arnold Schwarzenegger renewed his call for dramatic reform of the state's workers' compensation insurance program, warning "California employers are bleeding red ink" from the system.

"I call on the legislators to deliver real workers' comp reform to my desk by March 1st," Schwarzenegger said in his January 6 State of the State Address.

"Modest reform is not enough," he continued. "If modest reform is all that lands on my desk, I am prepared to take my workers' comp solution directly to the people and I will put it on the ballot in November."

Researchers for the San Francisco-

COMP p. 8

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Slovakia Adopts Personal Retirement Accounts

by John Skorburg

A former Soviet republic is moving to privatize its national pension system, adopting a system of personal retirement accounts similar to what the Bush administration has proposed for the United States.

Jose Piñera, architect of groundbreaking social security reform in Chile, is working to promote personal retirement accounts (PRAs) worldwide. Citizens for a Sound Economy (CSE) recently released a letter Piñera received from the minister of labor in Slovakia announcing the country's decision to privatize beginning in 2005.

"On Tuesday, the 16th December 2003,

SLOVAKIA p. 13

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FOREIGN POLICY

Retailers Cut Prices in Moscow as Sales Tax Ends

by John Skorburg

Russia's largest retail chains plan to lower prices 5 percent in response to the government's decision to drop the sales tax in 2004, according to the *Moscow Times*.

"All members of the Association of Retail Trade Companies, including such chains as Kopeika, Perekryostok, Paterson, Petrovsky, M.Video and Mir, agreed to cut prices on January 1," said Oleg Sazanov, the association's managing director. "Some companies will lower prices for their entire range of goods, others for specific items. But all of them will keep their promise," he said.

According to Gateway to Russia, a Web site developed in collaboration with the *Financial Times* to bring information on Russia's economy to the world, "This temporary tax was introduced in the summer of 1998 in order to make up for regional budget losses due to the 5 percent reduction in the VAT. In addition, the sales tax replaced 16 various local taxes and duties that existed previously."

In May 2003, according to the *Moscow Times*, Russia's largest retailers called a joint press conference and promised to cut their prices "by 5 percent if the government agreed to do away with the sales tax [in 2004]."

In December, Deputy Prime Minister Alexei Kudrin reminded retailers of their promise to cut prices, and the retail association officially confirmed its members would do so. Konstantin Mauergauz, chairman of Paterson, said "the chain had already lowered prices in its regional branches by 5 to 7 percent" in the waning days of 2003. "We would have done it in Moscow as well had it not been for technical difficulties—adjustments to our database, changing price tags. It will take about 10 additional days," he said.

Even retailers that did not sign the joint statement in May said they will lower prices.

According to the *Times*, "Metro Cash & Carry will no longer charge a 5 percent surcharge starting January 1." The company also announced it would lower prices to accommodate the decrease of the value-added tax from 20 percent to 18 percent in 2004. "The change of prices will be done through a unified, transparent, and fully automated system, and prices for all categories of items will drop in accordance with the change in legislation," the company said in a statement.

But Alexei Krivoshapko, a retail analyst with UFG, said the move made very little sense from an economic point of view and is unlikely to lead to better sales. "For the vast majority of consumers, the 5 percent price drop is unlikely to become a determining factor in a decision to buy," he said. "What are people going to do? Buy more condensed milk if it is [30 kopeks] cheaper?"

Itar-Tass Photos

Shoppers in a central Moscow department store take advantage of New Year's sales. Retailers lowered prices on January 1 as the Russian government did away with the country's sales tax.

The move could affect low-income customers, Krivoshapko acknowledged. But since those consumers often prefer cheaper traditional markets to western-style supermarkets, the price drop may go unnoticed, especially by more well-to-do consumers.

U.S. Nobel laureate economist Milton Friedman disagreed with the Russian analyst and applauded the tax cuts, primarily on the grounds that they help rein in growth of government spending.

"The only way to cut government down to size is through tax cuts," noted Friedman."Tax cuts that increase incentives to produce and that eliminate distortions in the price system—supply-side tax cuts—both restrain government spending and increase future income and current wealth."

According to Gateway to Russia, the sales tax had a negative effect on the market for goods and services. Retailers were forced to raise prices and as a result lost customers. "After the sales tax was introduced everyone raised their prices and sales declined, as consumers moved to wholesale-retail markets where prices stayed the same," representatives of Tekhnosila Company reported on the Gateway site.

The temporary sales tax had a particularly substantial effect on those making and selling food products. "After the sales tax was introduced, the number of loyal customers stayed the same but the overall amount of an individual purchase in bedroom communities fell," noted representatives of Russian food retailer Sedmoi Kontinent.

Retailers targeting less-wealthy consumers were also hard hit by the tax. "When the tax was introduced, we were focusing on rather price-sensitive market segments, the mid- and lower-mid price range, which meant that higher prices led to a reduction in demand of 10-15 percent," recalled Valeri Pokornyak, general director of Altan, a manufacturer of flour and pasta products.

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A Review of Tax Changes Taking Effect this Year

by Terry Savage

Tax law changes that take effect this year will make a difference in your personal finances. Some will happen automatically, and some of these new tax deals require you to take some action now.

■ **The tax cut**. Here's one change that will benefit all workers, and it will show up in your paycheck, because you'll take home more money. Clearly, it wasn't just the rich people who got a tax break. In fact, all taxable income above $28,000 will be taxed less this year than for 2003. And the lowest tax bracket of 10 percent now applies to the first $7,000 of income for singles and $14,000 for married couples. That's up from $6,000 and $12,000 last year—a big percentage tax cut for the lowest income bracket.

■ **Kids worth more**. Kids are worth a $1,000 credit against your 2003 taxes. You may have received an advance check of $400 last summer. If so, you can claim only the remaining $600 tax credit on your 2003 tax return. You'll get that full $1,000 credit on your 2004 tax return when you file next year. Plus, if you're employed and hire someone to help care for your children, you can get up to $3,000 in additional tax credits per child. The tax law is made up of incentives, but I'm not sure that $1,000 credit is enough incentive to have children—or offset their cost!

■ **Save more**. You can put away more money in your employer's 401(k) retirement plan this year—up to $13,000 if you're under 50 and an extra $3,000 if you're over 50. But you have to take action to ask your employee-benefits office to increase your monthly contribution. Most companies have reprogrammed their computers to automatically calculate the amount you need to contribute from each paycheck in order to reach the over-50 maximum. Just ask.

By the way, I recognize that many of my readers have no possibility of saving $13,000 a year because you need the money to live on. But if you put away just $3,000 a year for the next 30 years, and if your company matched your 401(k) contribution at 50 cents on the dollar, and if the money grew at just the average historic gains of the stock market (a bit over 10 percent with dividends reinvested) you'd have a cool $1 million in your 401(k) plan in 30 years. Now isn't that tempting?

■ **Rewrite your will**. Starting this year, you can exempt $1.5 million from the combined estate and gift tax—up from $1 million last year.

Just a few years ago that exemption was only $600,000. Since that was the figure for many years, estate plans established bypass trusts specifically referring to the $600,000 exemption. Make sure your will or living trust is flexible on that point, allowing for the annual increases and not specifying a fixed amount.

By 2010, the exemption will rise to $3.5 million. (That's the best year to die, if you're planning ahead, because the following year, 2011, the law reverts to the original higher rates and lower exemptions.)

■ **Keep investing**. If you hold investments more than one year, you'll pay a lower rate on capital gains. The maximum long-term capital gains rate for taxpayers in the highest brackets (25, 28, 33, and 35 percent) was cut to 15 percent on gains taken after May 5, 2003. And for taxpayers in the 10 percent and 15 percent brackets, the top rate drops to 5 percent. Taxes on dividends fall, too, with the top rate only 15 percent on dividends paid since January 1, 2003.

■ **Deduct college costs**. This year parents can write off $4,000 in college costs on their tax returns, up from $3,000 last year. Many parents of college students aren't aware they can take this deduction.

■ **Social Security payments**. Here's another automatic bonus. You'll get slightly more money in your Social Security check this year as a result of a modest 2.1 percent cost-of-living adjustment, but there is also something you won't see on your next Social Security check.

Starting January 1, the government removed your Social Security number from the check, the better to guard against fraud!

How is the government paying for that Social Security increase? It won't come out of your paycheck. Your FICA payroll deduction remains the same. It's just one more future IOU for the Social Security trust fund. In fact, there's one thing you might have noticed about all of these changes: They put more money in people's pockets. It's no coincidence that this is an election year. And that's The Savage Truth.

Terry Savage is a registered investment advisor and is on the board of the Chicago Mercantile Exchange and McDonald's Corp. She appears weekly on WMAQ-Channel 5's 4:30 p.m. newscast and is a columnist for the Chicago Sun-Times*, where this essay first ran on January 8, 2004.*
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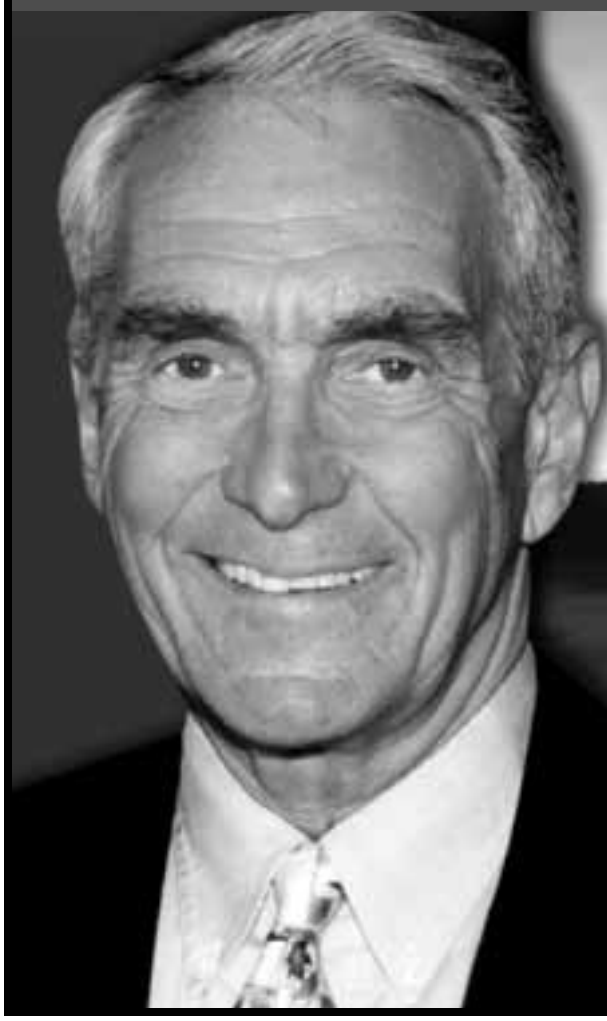

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Virginia Governor Proposes Largest Budget, Tax Increase in State History

by Geoffrey F. Segal

Virginia Governor Mark R. Warner (D) on December 17 presented his executive budget for the 2005-2006 biennium to the joint money committees of the commonwealth's General Assembly. Warner's proposed "Commonwealth of Opportunity" budget and tax reform plan were introduced on January 14 as House and Senate Bill 30, when the General Assembly opened its 2004 session.

The budget request was the largest in the commonwealth's 216-year history, to be funded by the biggest tax increase ever imposed on Virginia residents.

"In the first 23 months of this administration, we have worked to restore the fiscal integrity of Virginia, to make government more efficient, and to promote new economic opportunities for our people," said Warner. "These would be ambitious goals in the best of times—but these have not been the best of times."

The budget also included the unveiling of the governor's much-heralded "tax restructuring" plan. The plan includes several changes to the tax code—tax increases as well as tax reductions. "We have grappled with more than $6 billion in shortfalls, and worked hard to streamline government and change the ways it does business," said Warner. "Now we have come to a place where state government must begin to meet its commitments fully."

"Irresponsible" Tax Increase

Warner's plan would increase the overall tax burden on Virginia taxpayers by more than $1 billion in the upcoming biennium budget.

"The governor was irresponsible to not even consider where this budget can be trimmed," accused Delegate L. Scott Lingamfelter (R-Prince William), who has said he will not support new taxes. Lingamfelter said he hopes to look closely at how the state can spend money more efficiently. "We're already seeing signs of recovery, and the governor should let the economy correct itself."

The governor has said the tax restructuring plan is needed to "make the system of collecting taxes more fair." Under the governor's proposal a new and higher tax bracket would be created for families earning more than $100,000 (from 5.75 percent to 6.25 percent). Furthermore, the governor proposed increasing the state sales tax on cigarettes from 2 cents per pack to 25 cents per pack, and he also would authorize local governments in the commonwealth to enact an additional tax of up to 50 cents per pack.

"There's nothing in his plan that addressed the funding imbalances we suffer from," said Delegate David B. Albo (R-Fairfax), who, like Lingamfelter, said he thinks the government can be run more efficiently.

Regional differences also appear to be a problem for the governor's plan. "Here in Northern Virginia, we contribute about 40 percent of the state's income tax, with about a quarter of the population," said Delegate Vincent F. Callahan Jr. (R-Fairfax), chairman of the House Appropriations Committee. "With the governor's plan, it could take it to about 50 percent. That concerns me."

Not Revenue-Neutral

The governor's plan is not exclusively tax increases. He proposes lowering the state income tax on the first $20,000 of income, increasing the standard deduction and dependent exemption amounts, and lowering the state sales tax on food from 4 percent to 2.5 percent.

However, Senator Bill Bolling (R-Hanover) suggested "the goal of true tax reform must be to devise a tax code that is fairer, simpler, and better positions the Commonwealth to take advantage of future revenue growth in a changing economy. And a guiding principle of true tax reform must be revenue neutrality for the Commonwealth.

"Stated differently," he continued, "tax reform should not result in an increase in the overall tax burden for Virginia's families or businesses. If it does, it is not tax reform, it is a tax increase in disguise. Clearly, the governor's tax plan includes very little in the way of true tax reform. It is primarily a tax increase in disguise."

Delegate Gary Reese (R-Centerville) added, the "governor's got it backwards, what we need is budget reform to determine the kind of Virginia we want in the twenty-first century. We need a transparent budget and priorities before tax reform." Reese authored the Taxpayer Bill of Rights, which passed both houses of the General Assembly unanimously last year and was signed by the governor. It requires the state to produce a readable budget with performance and cost data at its heart.

U.S. Senator George Allen (R-Virginia) expressed concern in a letter to state Senate Majority Leader Walter Stosch (R-Henrico County) that "the positive economic effects for Virginians from the tax reductions we have enacted at the federal level not be undermined or jeopardized by large state tax increases."

Governor Mark Warner (D-Virginia)

The governor's proposed biennial budget includes nearly an 8 percent increase in FY 2005 and nearly 4.5 percent increase in FY 2006. The governor has suggested the $1 billion tax package is needed to prevent cuts in the budget, fully fund Medicaid, re-fund the rainy day fund, and implement "standards of quality" (SOQ) improvements in education.

Over the past few years, several tax and expenditure limitation (TEL) bills have been introduced in the Virginia General Assembly. None has passed. In 2003, a bill carried by Assembly Appropriations Chairman Callahan would have limited spending growth to 8 percent a year, which would have allowed the budget to double every nine years. The bill passed the House but was not considered by the Senate.

"The governor was irresponsible to not even consider where this budget can be trimmed. We're already seeing signs of recovery, and the governor should let the economy correct itself."

DELEGATE L. SCOTT LINGAMFELTER

At least three TEL proposals have been submitted to the General Assembly for consideration in 2004. They include provisions to limit spending to the rate of population and inflation increases, and provide for a stabilization fund, tax refunds, and grants to local governments for special infrastructure projects.

Geoffrey Segal is director of privatization and government reform policy in Reason Public Policy Institute's Privatization and Government Reform Center. His email address is **geoffrey.segal@reason.org**.

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Virginia Has Its Own California Problem

by Stephen Moore

If you watched the recall of Governor Gray Davis and the elevation of Arnold Schwarzenegger in California, you know the Golden State is in dire fiscal shape.

This is a state that has taxed and spent itself into near oblivion. California is now drowning under $14 billion of debt, has one of the highest unemployment rates of any state in the country, and has a bond rating barely above junk bond status.

How did this happen? As Schwarzenegger has said many times: "Our politicians have spent us into the poorhouse."

Overspend and Overtax

And if Virginia doesn't soon change its ways, it's headed into the winds of the same fiscal storm that has ruined California. The similarities between the two states are frighteningly striking.

California's economic crisis stems from chronic overspending by the governor and state legislature, which saw the state government grow by more than 40 percent in just five years. But Virginia's budget grew at an even more reckless pace than California's. In Richmond the state budget expanded by 56 percent over the same time period. The chart at right shows that in recent years both taxes and spending have increased at a faster pace in Virginia than in the once-Golden State.

High-Tech Boom, Bust

Virginia and California both benefitted enormously from the high-tech revolution of the 1990s. Northern Virginia has more high-tech companies than any area in the country outside Silicon Valley.

During the technology sector's boom years, the two states were awash in tax revenues. Both California and Virginia nearly doubled their tax intake in the 1990s. However, the high-tech bust of 2000 and 2001 left a big financing hole in each state's budget.

Former California Governor Gray Davis refused to cut the state budget to fill that hole. Instead, he issued record levels of new debt and raised taxes. To make the tax system "fairer," Davis imposed tax hikes on the rich and on business.

But California, like Virginia, already had a tax system where the "rich" shouldered a huge share of the tax burden. The richest 1 percent of Californians pay about one-third of all the state's income taxes. Virginia isn't quite that top heavy in taxes, but the rich do shoulder a disproportionate share of the burden.

Virginians should pay close attention. Higher taxes in California, combined with a culture in Sacramento that is hostile to business, led to the first major out-migration of wealthy individuals and businesses in the state's history. California's entrepreneurial community especially is uprooting itself and moving to Idaho, Nevada, Utah, Washington, and other neighboring states that have much lighter tax burdens.

Virginia Governor Mark Warner is now pursuing many of the same economically debilitating policies. In 2002 he tried to solve the transportation "crisis" by raising sales taxes. Now he is promoting a tax restructuring scheme that would make the tax system "more equitable."

Guard your wallet. This sounds an awful lot like a stalking horse for increasing income tax rates on middle- and higher-income Virginians. But Californians have learned that high tax rates don't redistribute income, they redistribute people. People are repelled by high taxes in much the same way they are repelled by a swarming cloud of bees. If the politicians raise taxes on the rich, there will be fewer rich people in Virginia. That will also mean fewer jobs and fewer tax revenues. That's exactly what happened in California.

Time to Cut the Budget

So how can Virginia avoid California's sad demise?

To start, Warner and the legislature need to start making cuts in the budget now, so the fiscal crisis doesn't cascade out of control the way it did in Sacramento. Despite lip service to what we are told were draconian budget cuts last year, the budget in Virginia has not only grown, but grown faster than inflation and population in every year of the Warner administration. Borrowing at the state and local level in Virginia has also exploded in recent years. This just makes balancing the budget in the future all the more difficult.

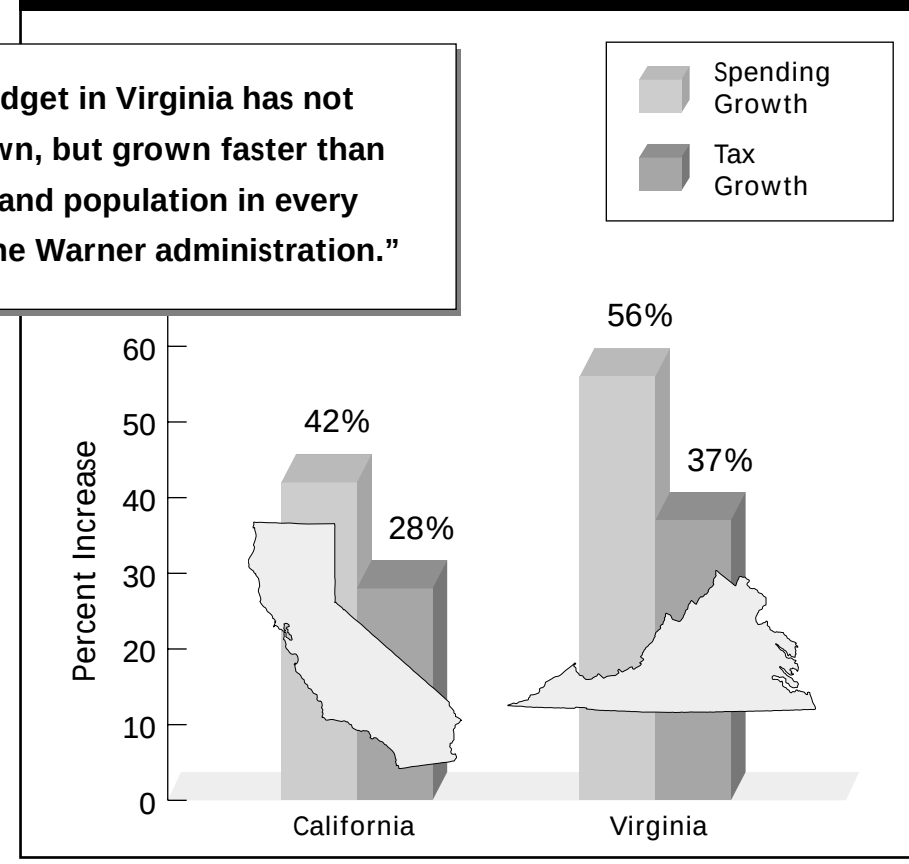
Gray Davis was removed from office because infuriated voters felt he allowed their state to slip into a fiscal ditch and had no viable plan to pull the state out of its decline. The combination of high taxes, onerous business regulations, runaway trial lawyers, and $50 billion of new debt by the state government drove individuals and business to sanctuaries of political sanity outside California's borders.

California's predicament is a result of inept and cowardly leadership and an inability of the politicians in that state to say no to parades of moneyed special interests. I see the same maladies creeping into the political structure of Virginia. In California, the bloom is off the rose. It would be a shame if the Commonwealth of Virginia suffered the same unhappy fate.

*Stephen Moore is president of the Club for Growth and a senior fellow at the Virginia Institute for Public Policy (**http://www.virginiainstitute.org**), an education and research organization headquartered in Potomac Falls, Virginia.*

"[T]he budget in Virginia has not only grown, but grown faster than inflation and population in every year of the Warner administration."

1997-2002 Per Capita Budget Growth



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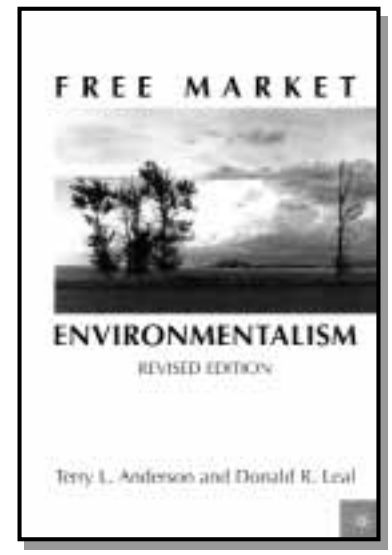

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Pennsylvania Legislature Finishes Only Half of Budget Business

Tax increase supercedes property tax cut

Rep. Jeff Coleman (R-Apollo)

Rep. Daryl Metcalfe (R-Butler)

Rep. Sam Smith (R-Punxsutawney)

Rep. Curtis Thomas (D-Philadelphia)

by John Skorburg

Although they did not get the property tax relief measure they were holding out for, the Pennsylvania House of Representatives nevertheless voted 104-89 on December 22 to approve $1 billion in new taxes to finance new programs and close a state budget deficit. The property tax measure had been promised as a way to offset the new tax burden.

The tax increases were included in a package of bills passed by the Senate on December 20. Governor Edward G. Rendell, a Democrat, signed the package on December 23, ending Pennsylvania's distinction as the only state in the nation without a completed spending plan for the new fiscal year.

House members had insisted on property tax cuts as a tradeoff, but 11th-hour Senate negotiations over a proposal to provide property tax rebates funded by legalizing slot machines collapsed before the House vote.

Rendell said he had assurances from legislative leaders that resolving those differences would be a top priority when lawmakers returned to the capitol in January. "We will, I repeat, we will give people property tax relief," he said.

The legislative package signed by Rendell calls for the state income tax rate to rise from 2.8 percent to 3.07 percent—an increase of nearly 10 percent—to raise an additional $729 million a year. A household with taxable annual income of $50,000 would owe $135 a year more in income taxes. The package also includes a 35 cents-per-pack boost in the $1 cigarette tax.

A Difficult Vote

Seventeen speakers, many of them Republicans who spoke against the bill, took the House floor before the body voted on the tax increase package.

Reps. Dave Reed (R-Indiana) and Jeff Coleman (R-Apollo) were among those who voted against the bill, while House Majority Leader Sam Smith (R-Punxsutawney) voted in favor.

Smith pointed out that Rendell first proposed raising the state personal income tax from the current 2.8 percent to 3.75 percent—a 34 percent increase. "In the end, we cut that increase by two-thirds, to just under 10 percent," Smith wrote in a press release. "It was difficult," he said after the vote. "I don't take voting to raise people's taxes lightly."

Coleman's vote against the package reflected his persistent opposition to any state tax increase. "It is the absolutely wrong direction for the state of Pennsylvania," he warned.

Reed agreed, noting "I don't think that this is a smart thing to do in this kind of economic year." He said that although Pennsylvania's economy had been expected to be poor in 2003, the state has "rebounded and seen a [turnaround] of more than $284 million."

About one-third of the 108 Republicans supported the plan, but several GOP opponents said it represented excessive, unnecessary spending. "The state has been spending like a drunken sailor," said Rep. Will Gabig (R-Cumberland). "As a sailor myself, I know we have been spending like drunken sailors."

"The governor and his friends are about to take Pennsylvanians for another ride down the tax-and-spend expressway, a trip that will end in a destructive economic accident," said Rep. Daryl Metcalfe (R-Butler). "The right choice is the choice of government living within its means."

Democratic supporters said Rendell needed the tax increases in part to fix a $1.8 billion structural deficit he inherited. "This is not a pretty piece of legislation. ... It's ugly, but it's necessary," said Rep. P. Michael Sturla (D-Lancaster). "It's time to acknowledge the structural deficit. I fully expect we will be back here in January, and maybe it will take until February, until we get property tax relief."

"The people of my district say no to taxes, but yes to increased education funding," said Rep. Curtis Thomas (D-Philadelphia). "This tax increase is not desired ... but we can't talk about having the best without talking about what we need to do to get it."

Business Community Relieved

While stressing that much work remains to make the commonwealth's business tax structure more conducive to job creation, the Pennsylvania Chamber of Business and Industry commended legislative leaders for resolving the budget dispute.

"The governor and his friends are about to take Pennsylvanians for another ride down the tax-and-spend expressway, a trip that will end in a destructive economic accident. The right choice is the choice of government living within its means."

REP. DARYL METCALFE

"Pennsylvania's business community was braced for a tremendous hit early on in the budget process," said Jim Welty, vice president of legislative and corporate affairs for the Pennsylvania Chamber. "Balancing the budget solely on the back of business, which already contends with a tax structure that is one of the most onerous and complex systems in the nation, would have had a disastrous impact on job creation and economic growth."

Welty said the Chamber remains steadfast in its position that any new taxes on business or increases in existing business taxes are regressive and counter-productive to the economic recovery that appears to be at hand.

"We should be fostering business and job growth. Pennsylvania's tax structure should be a selling point for new businesses to locate here and for existing companies to stay and grow," he said. "Unfortunately, it has become a selling point other states can use to lure job opportunities away."

Legislators Coleman and Reed said they were unhappy the House passed a tax hike without "any accompanying provisions for property tax reform." Coleman noted Rendell had earlier promised that any increase in state taxes would be offset by a dollar-for-dollar reduction in local property taxes. "Note the tune has changed," he said about Rendell's willingness to look at a tax increase without accompanying reforms.

"What does a family that has lost a substantial amount of its income do in order to keep paying bills and buying groceries?" asked Jake Haulk, president of the Allegheny Institute for Public Policy, in a December 6, 2002 policy brief. "Most families in such a situation would finds ways to reduce their spending, postpone major purchases, eliminate frills, and generally tighten their belts until their financial picture improves. It seems logical and reasonable that state and local governments would do the same."

"There were some disappointments," acknowledged Rendell after the vote. "All of us regret that we couldn't fulfill my promise to get property tax relief to the people. We will take up property tax relief first when we return in January."

John Skorburg is managing editor of Budget & Tax News. *His email address is* **skorburg@heartland.org**.

INTERNET INFO

For more information about the Allegheny Institute for Public Policy, visit its Web site at **http://www.alleghenyinstitute.org**.

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Dean

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failure of leadership.

"He earned a rank of '3' from ATR," Norquist said. "He did not demonstrate convincingly that he cared one way or the other about taxpayers.

"It doesn't help that Dean signed a law in 1997 that weakened the sovereignty of localities to decide whether to increase property taxes or not, and empowered the state with that authority," Norquist continued. "Since 1998, property taxes have increased by leaps and bounds, more than they would have if the old laws were in place."

15 Governors Get Lowest Ranking

Dean was among 15 governors, identified in the accompanying sidebar, to whom ATR has given a rank of "3."

Alabama's Bob Riley proposed a $1.2 billion tax increase package that was soundly defeated by referendum voters, 68 percent to 32 percent. Riley's plan would have increased taxes by $293.21 per person, or $1,172.84 for a family of four.

"If we had a lower rank than '3,' which we considered creating in Riley's case, and in the case of Gray Davis, both of them would have earned it," commented Norquist. "Thankfully, voters in Alabama have more sense than the governor they elected."

Arkansas' Mike Huckabee asked the legislature to approve income and cigarette tax increases the same day President George W. Bush was in Little Rock promoting his economic and jobs growth tax relief plan in spring 2003. Spending has increased 65.3 percent during Huckabee's tenure as governor.

As reported in *The Washington Times* on December 2, Huckabee attacked Norquist for his opposition to tax increases. "'Grover needs to run for governor somewhere, win and then try to govern,' Mr. Huckabee added. 'He makes it sound so easy.'"

Norquist replied, "'He should make a phone call to Texas Governor Rick Perry, who closed a $10 billion deficit without tax hikes, or Minnesota Governor Tim Pawlenty, who closed a $4.2 billion deficit without tax hikes. It isn't easy. It is called governing.'"

John Rowland of Connecticut, Ruth Ann Minner of Delaware, and Dirk Kempthorne of Idaho also actively promoted tax increases. "Rowland is particularly disappointing because he signed the Taxpayer Protection Pledge promising to oppose and vote against any and all efforts to increase taxes," said Norquist. "Breaking your pledge, a document that Rowland signed, ostensibly while sober, and then breaking that pledge is a real slap in the face for taxpayers."

In Iowa, Tom Vilsack maintains that a proposal to increase cigarette taxes "is not a tax increase."

"Look, if it smokes like a tax increase and clicks like a tax increase, it's a tax increase," commented Norquist. "Any increase in taxpayers' burden that isn't offset by other, simultaneous actions to reduce that burden is a tax increase."

Missouri's Bob Holden, Mike Rounds of South Dakota, and Mark Warner of Virginia also earned a rank of "3" from ATR for raising taxes.

"Some of these guys just won't quit, like Mark Warner. He just released his so-called 'Tax Reform' plan that includes, among other efforts to increase taxes, an attempt to revive a regional sales tax," said Norquist. "Voters didn't split hairs last year—they told Mark Warner that they did not want a regional sales tax. And yet here he is again, singing the same tune."

How to Move Up in Ranking

"Part of the problem with poorly ranked governors is that they just don't learn by example," noted Norquist. "Tax increases demonstrably reduce economic growth and prosperity. They cut job growth and investment in new businesses and technology. It's not rocket science.

"Cut spending, provide tax relief, use the private sector to provide alternatives to traditional spending methods such as investment in charter schools, eliminate state jobs that haven't been filled in years, review state property holdings and re-evaluate office space needs, combine agencies and commissions that perform the same services, refinance state debt and for the sake of sanity, stop micro-managing every detail at the state level," he added.

"That's what I call leadership, and those kinds of policies will earn a governor a rank of '1' or—even better—a Gold Star award. A little something ATR provides good governors with to pin to their lapels at the National Governors Association meetings," ended Norquist with a smile.

*Emily Sedgwick Ansell is recently married (November 2003) and an analyst for Americans for Tax Reform (***http://www.atr.org***).*

ATR's Worst-Ranked Governors

- **Bob Riley** (R-Alabama)
- **Mike Huckabee** (R-Arkansas)
- **John Rowland** (R-Connecticut)
- **Ruth Ann Minner** (D-Delaware)
- **Dirk Kempthorne** (R-Idaho)
- **Tom Vilsack** (D-Iowa)
- **Jennifer Granholm** (D-Michigan)
- **Bob Holden** (D-Missouri)
- **Jim McGreevey** (D-New Jersey)
- **Bob Taft** (R-Ohio)
- **Ted Kulongoski** (D-Oregon)
- **Ed Rendell** (D-Pennsylvania)
- **Mike Rounds** (R-South Dakota)
- **Howard Dean** (D-Vermont)
- **Mark Warner** (D-Virginia)

Taxpayer Advocates Battle Tax Increases

by Emily Sedgwick Ansell

In Nevada, Dan Burdish of Nevadans for Tax Restraint and George Harris of Nevadans for Sound Government are leading the fight to repeal part of Democrat Governor Kenny Guinn's $776 million tax increase package, passed in July 2003. Burdish and his team must collect 51,234 signatures from registered voters by May 18, 2004 to repeal Guinn's $358 million in new payroll taxes on financial institutions, including banks.

In New Jersey, a similar campaign to oppose a gas tax increase earned more than 8,000 signatures in just one week. Democrat Governor Jim McGreevey's blue ribbon commission proposed increasing the gas tax by 12.5 cents per gallon to pay for transportation spending—even though the governor said he is against such an increase.

In Ohio, Secretary of State Kenneth Blackwell is leading a petition drive to repeal Republican Governor Bob Taft's $2.9 billion tax increase plan from 2003. State Senator Kevin Coughlin (R-Cuyahoga Falls) introduced SB 159 on December 4 to repeal Taft's 1 cent sales tax increase.

In Oregon, Jason Williams of the Oregon Taxpayers Alliance is "working to secure signatures to repeal Democrat Governor Ted Kulongoski's $201.3 million tax increase plan." Kulongoski actively supported the income tax surcharge and business-related tax increases that voters may have the opportunity in November 2004 to repeal.

"Taxpayers and their advocates in Nevada, New Jersey, Ohio, and Oregon have demonstrated that they will not accept…attempts to raise taxes…."

GROVER NORQUIST
AMERICANS FOR TAX REFORM

"Taxpayers have voices," commented Grover Norquist, president of Americans for Tax Reform. "Taxpayers and their advocates in Nevada, New Jersey, Ohio, and Oregon have demonstrated that they will not accept their governors' and legislatures' attempts to raise taxes without first hearing from voters.

*Emily Sedgwick Ansell is recently married (November 2003) and an analyst for Americans for Tax Reform (***http://www.atr.org***).*

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California Blueprint for Workers' Comp Reform

by Lawrence McQuillan and Andrew Gloger

Workers' compensation is a worthwhile program that works well in most states. California's program, 90 years old, should be salvaged.

But lawmakers must rewrite workers' comp rules before more damage is done to the state's economy. Every dollar spent on increased workers' comp insurance premiums is one less dollar available to hire new employees or provide better benefits to existing employees.

The Pacific Research Institute has proposed a comprehensive structural solution to the state's workers' compensation crisis without the need for price controls on insurance premiums. If enacted, it would save employers billions annually and put the workers' compensation system on sound financial footing. This would encourage new hiring, return luster to the Golden State's business climate, and promote future prosperity for all Californians.

The following points summarize major recommendations in five key areas.

1. Benefits, Eligibility, Administration

The first action should be to defer scheduled benefit increases until average workers' comp premium rates in the state fall to the national average.

2. Medical Spending

Since 1997, average medical costs per California workers' compensation claim have increased nearly 20 percent per year. Over that same period, by contrast, the Consumer Price Index for medical services has increased, on average, less than 4 percent per year. Further reforms must be made to control medical costs.

3. Disability Claims Process

The number of disability claims in California is almost three times the national rate. In 2002, California saw 1,221 claims per 100,000 workers, compared to 434 nationally. Permanent disability payments per injured worker in California are also three times the national average.

"The blueprint offered here … would save employers billions annually and put the workers' compensation system on sound financial footing."

4. Vocational Rehabilitation

The workers' comp reform passed by the legislature in late 2003 repealed the previous vocational rehabilitation benefit for disabled employees, replacing it with a $4,000 to $10,000 education voucher for those who are not offered re-employment. This new provision also should be repealed. Disabled employees are fully indemnified for lost earnings by disability benefits. The employee, not the previous employer, should pay for any retraining or skills-enhancement education. To do otherwise would allow some to gain from their disability. Moreover, if employees pay for their own vocational rehabilitation, retraining success rates would rise.

5. Litigation and Penalties

California's workers' compensation system was originally designed to minimize litigation. But something went wrong along the way.

Of the roughly one million workers' comp cases filed each year, about 20 percent are contested. By contrast, Arizona litigates only 6 or 7 percent of its cases. Worse yet, 76 percent of Californians' permanent disability cases end up in litigation.

Implementing the above recommendations on medical and disability benefits would inject greater objectivity into the system and help reduce litigation costs. But other changes also must be made:

- Compensate only those injuries that are *predominantly* caused by the workplace—meaning more than 50 percent caused by the job—not *proximately* caused.
- Change the medical care standard from cure and relieve to "medically necessary," the same standard that applies to group health insurance.
- Restructure the permanent disability rating system according to American Medical Association guidelines for determining physical impairment, used by most states.

Dr. Lawrence McQuillan

Lawrence McQuillan is director of, and Andrew Gloger is a policy fellow in, PRI's Business and Economic Studies department. They can be reached by email at **lmcquillan@pacificresearch.org** *and* **agloger@pacificresearch.org**, *respectively.*

INTERNET INFO

The full text of *How to Fix California's Broken Workers' Compensation System*, released by Pacific Research Institute on December 17, 2003, is available from the PRI Web site at **http://www.pacificresearch.org/pub/sab/entrep/Workers_Comp.pdf**.

Comp

Continued from page 1

based Pacific Research Institute (PRI) could not agree more on the need for substantive reform.

"Legislation was signed in fall 2003 to fix flaws in the system," said Dr. Lawrence McQuillan, who with Andrew Gloger is author of *How to Fix California's Broken Workers' Compensation System*, a PRI report released on December 17, 2003. "But it did not go far enough. A second round of reforms is needed to fix this broken system."

Schwarzenegger convened a special session of the state legislature on November 18 to address the crisis, and legislation reflecting the governor's desired reforms has been introduced. California Insurance Commissioner John Garamendi, a Democrat, also has released a reform proposal.

"Clearly, both political parties recognize the gravity of the problem," noted PRI.

Background

California's workers' compensation system was launched in 1913 as a no-fault system to provide medical treatment and disability benefits to employees injured on the job and to protect employers from liability and litigation. Employers are required to purchase insurance, or to self-insure, to cover the medical costs of injured workers and to indemnify workers disabled by work-related injuries for lost wages and impairment.

The system has worked well, notes the PRI study, until recently. Workers' compensation costs in the Golden State have tripled since 1997, accounting for up to 40 percent of payroll expenses. California employers now pay the highest workers' compensation premiums in the nation, yet injured-worker benefits rank almost last.

"Given these cost differences, it is no surprise that California has lost 250,000 manufacturing jobs since 2000," report McQuillan and Gloger. "Rather than pay these steep premiums, firms are moving out of state or going out of business. Buck Knives, Countrywide Financial, Fidelity, and 3Com have sought greener pastures outside California, citing soaring workers' comp costs. Whether for-profit, nonprofit, or government, almost every entity has been hit by staggering premium increases," they note.

Thomas Magowan, president of San Francisco-based Club Minibar, reports his company's workers' compensation rates in California went from "6 percent of payroll in 1999 to a hefty 17 percent in 2002, a nearly 200 percent increase in only three years, despite having just one claim in that period for less than $2,000." In 1999, Magowan paid 11 percent more in California than he did in Illinois. In 2003, he paid 408 percent more in California than Illinois, and 520 percent more than in Washington, DC.

Round One of Reform

In the final days of the 2003 session, the state legislature passed a workers' compensation reform package signed by Gray Davis on October 1, just days before voters recalled him from office. The reforms became law on January 1, 2004.

The first round of reforms targeted skyrocketing medical costs, which account for nearly 60 percent of workers' comp premiums. Limits were placed on the number of allowable chiropractic visits and physical therapy treatments. Guidelines for medical treatments were established and employers were required to monitor compliance with those guidelines. Fees for outpatient surgery centers were tied to Medicare rates and pharmaceutical prices were tied to Medi-Cal rates.

According to the Workers Compensation Insurance Rating Bureau (WCIRB), the agency designated by state officials to compute premium recommendations, the 2003 reform package will provide $4.2 billion in ongoing annual savings for employers. WCIRB recommended premium rate cuts of between 2.9 percent and 5.3 percent on January 1.

Round Two

The California Labor Federation has called for price controls on insurance premiums as the next step in workers' comp reform. Federation President Tom Rankin backs price controls because he believes "there is not much else that can be done in other areas [of workers' comp reform] without hurting injured workers."

State Senator Richard Alarcon, a Democrat and chairman of the Labor and Industrial Relations Committee, which handles workers' comp legislation, has threatened to provide regulatory authority to the insurance commissioner to force carriers to lower premiums. He added he would like to see voluntary rate reduction, "but if you force our hand, we will do it."

"But price controls always create more problems than they solve," warned PRI's McQuillan and Gloger. "Instead, further structural reforms are urgently needed that will cut premiums for employers, yet not reduce benefits for deserving injured and disabled employees."

"This objective can be achieved by bringing together the best features of the Garamendi and Schwarzenegger plans and incorporating ideas from legislators and system insiders," they noted.

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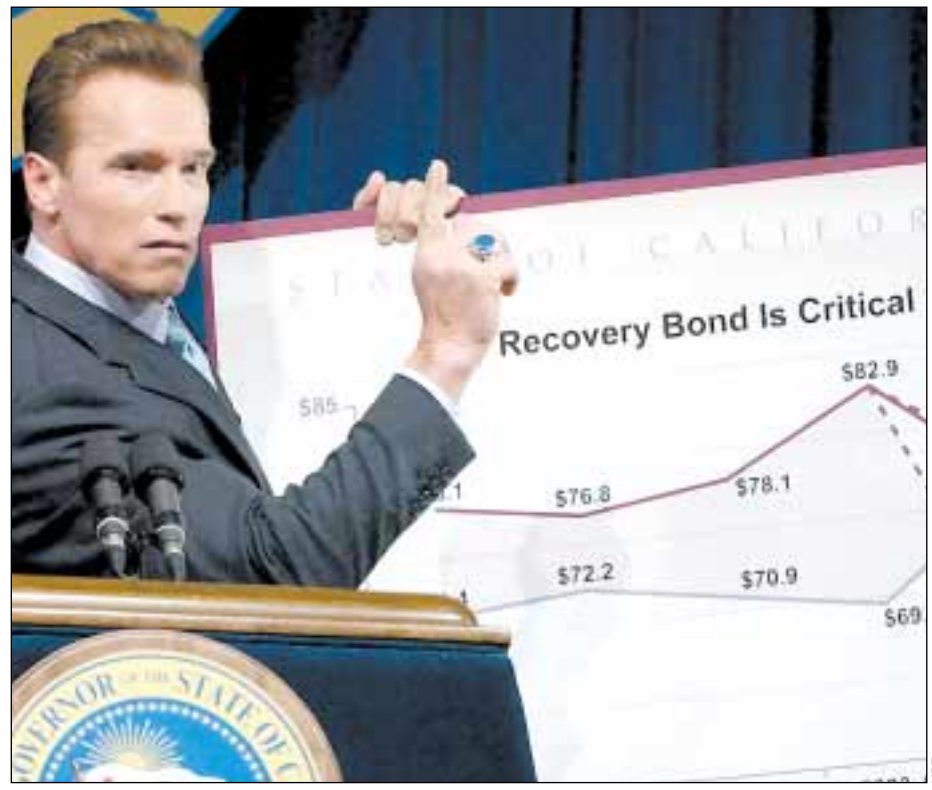
Schwarzenegger Caves on Spending Limit

by Michael New

California Governor Arnold Schwarzenegger abandoned a core campaign promise in mid-December when he signed a fiscal-reform package that did not include a constitutional spending limit. The plan includes a bond to cover the state's current budget deficit, but replaces the spending limit with a provision that merely strengthens California's existing balanced budget amendment. The governor's package cleared both chambers of the state legislature by wide margins and will be placed on the ballot for a March referendum.

Unfortunately, the package—assuming it's approved by the state's voters—will do little to help California avoid future budget shortfalls. The state's fiscal problems stem directly from the massive increase in spending during Gray Davis's administration. Between 1998 and 2001, on Davis's watch, spending increased by a whopping 48 percent. Because the state was running surpluses for most of that time, a more stringent balanced budget amendment would have done little to limit spending or solve California's current fiscal woes.

Conversely, a well-designed spending limit would have halted this expansion of government and prevented the current fiscal crisis. If spending had grown by the inflation rate plus population growth since 1998, the 2003 budget would have been $14 billion less and the accumulated surpluses would have totaled more than $50 billion. That would easily pay down the state debt and leave a tidy sum for tax relief.



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California Governor Arnold Schwarzenegger presents the 2004-2005 state budget during a news conference on Friday, January 9, 2004 in Sacramento, California.

Balanced Budget Amendment Not Enough

Some would argue that the stricter balanced budget amendment up for a vote in March would still be a victory of sorts. Coupled with California's two-thirds supermajority requirement for tax increases, it would theoretically prevent the legislature from issuing debt and force lawmakers to make serious spending cuts during fiscal shortfalls.

That upbeat view may be misguided for a few reasons. First, unions have placed an initiative on the March ballot that would lower California's supermajority threshold to 55 percent.

Secondly, California's fiscal constitution contains a number of spending guarantees for education and other public services. When fiscal limits conflict with spending mandates, judges almost invariably rule in favor of the mandate. Because California courts have often issued rulings hostile to the tax limits included in Proposition 13, the supermajority provision provides Californians with a false sense of security. That makes the case for a constitutional spending limit even stronger.

The December signing ceremony capped an intense, highly unusual period of negotiations between Schwarzenegger and key legislators. During the recall campaign, Schwarzenegger, Tom McClintock, and other Republican candidates all vowed to strengthen California's existing spending limit. In early December, Schwarzenegger made good on that promise. He introduced just such a proposal and began negotiations with state legislators.

The negotiations began inauspiciously, however. The governor's original proposal established a limit that was identical in size to California's current spending limit—the same limit that failed to stop the sharp increases in spending that occurred during the Davis administration.

Subsequent statements by Donna Arduin, director of California's Department of Finance, indicated the governor wanted a lower limit, one that would restrict spending increases to the inflation rate plus population growth. That is identical to the rate of growth established by California's original spending limit, known as the Gann Limit, which was in effect between 1979 and 1988. It is also the same limit set by budget caps in Colorado and Washington, which enjoyed success limiting spending during the 1990s.

Most Democrats in the California legislature were unwilling to support a strict spending limit. Most legislators tend to be reflexively hostile to any efforts that limit their autonomy, and California legislators proved to be no exception. The December 5 deadline passed, and Schwarzenegger announced plans to launch an initiative campaign to place a reform plan on the November ballot.

There would have been a number of advantages to this approach. Schwarzenegger could have ensured his proposal enjoyed broad support among conservatives, Republicans, and the business community. Furthermore, because his spending limit would have been placed directly on the ballot, there would have been no risk of it being corrupted through legislative compromises. That is what makes very puzzling his decision to essentially surrender and agree to a fiscal package without a spending limit.

All is not lost, though. In the aftermath of the December vote, several assembly Republicans, dissatisfied with the compromise, promised to continue to promote a constitutional spending limit. One of California's taxpayer groups may be able to collect the signatures necessary to get a proposal on the November ballot. It remains a worthy cause, even if the current administration has lost interest.

Michael New is an adjunct scholar with the Cato Institute. This article first appeared in National Review Online on December 16 and is reprinted here with permission.

Oregon Should Follow the Example of Florida, Outsource Human Resource Services

by Geoffrey Segal

A tax recall vote on Oregon's February 3 ballot is just one indication that taxpayers nationwide prefer spending cuts, rather than tax increases, for balancing state budgets.

"175,000 taxpayers have made a dramatic statement to Oregon politicians that we will no longer tolerate business as usual," said Oregon State Representative Jeff Kropf (R-Halsey). "They are demanding that government become efficient and do more with less."

This attitude, growing among taxpayers nationwide, will force state leaders to focus on innovative ideas, as opposed to business-as-usual taxes and fees, while putting their states' budgets back in balance.

Florida Example

Rather than cutting essential services or raising taxes, Florida state officials have looked for innovative and creative ways to introduce private-sector efficiency and effectiveness into operations the private sector can perform better than the state can.

In August 2002, Florida signed a contract with Cincinnati-based Convergys Corp. to administer almost all of its routine personnel functions, including payroll, insurance benefits, employee training, and recruiting for 189,000 state employees.

"Working with Convergys enables us to provide the highest quality human resources services possible to the men and women who dedicate their careers to public service," said Governor Jeb Bush (R). "Leveraging Convergys' service delivery expertise, resources, and technology, we can expand and improve the human resources services our employees receive while saving Florida taxpayers millions of dollars."

According to the State of Florida's Department of Management Services, the contract will save the state an estimated $173 million over seven years. Florida will not only avoid $80 million in capital spending to replace the state's aging human resources computer systems, but will also cut millions of dollars in recurring expenses.

Human resources outsourcing allows Florida to spend fewer dollars on administrative tasks. The contract "allows state employees and managers to focus on their core mission of serving the citizens of Florida," said Bush.

"State governments are in the unique position of serving two 'customers'—their employees, who need and deserve excellent employee services, and their citizens, who want the best value for their tax dollars," said Karen Bowman, president of Convergys Employee Care. "The HR specialists and systems Convergys deploys will allow Florida to retain excellent employees and operate more efficiently while delivering taxpayers a solid return on their investment."

Florida, the fourth most populated state in the United States and the first major state to outsource human resources services, selected Convergys after completing an extensive competitive analysis of more than a dozen outsourced services providers.

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PART 2 OF A THREE-PART SERIES

On the Frontier: Colorado's Taxpayers Bill of

by Lew Uhler and Barry Poulson

Colorado is often cited as the state with the most stringent tax and expenditure limit (TEL) in the country. State elected officials nationwide can learn from how Colorado got its TEL and how it is attempting to cope with recent challenges.

Colorado's Tax Revolt

One of the most important changes in Colorado tax policy was the adoption in 1987 of a flat income tax set at 5 percent, replacing the graduated income tax. The 5 percent flat rate was not revenue-neutral, capturing much of the windfall from the federal income tax reform of 1986. The income tax burden on Colorado citizens increased significantly, and the state became increasingly reliant on the income tax as a source of revenue.

This increased tax burden, and the rapid growth of government it paid for, set the stage for a tax revolt. A small group of tax fighters, led by Douglas Bruce, garnered the signatures needed to place the Taxpayer Bill of Rights (TABOR) initiative on the ballot. Initially, the measure lost to a coalition of powerful interest groups both public and private. But in 1992 the TABOR won the majority vote required for adoption as an amendment to the state constitution.

Colorado's TABOR is currently the most stringent tax and spending limit in the country. Any increase in taxes, fees, or debt, at either the state or local level, must be approved by the voters. TABOR limits the amount of revenue growth the state can retain and spend to the sum of inflation and population growth. Revenue growth above that limit must be rebated to taxpayers. A similar limit is imposed on the growth of revenue and spending at the local level. The legislature can seek approval from taxpayers to spend surplus revenues.

In the 1990s Colorado experienced one of the most rapid rates of economic growth in the country. But state revenues increased even faster than the growth in personal income. Before TABOR kicked in, the state went on a spending spree, building highways, prisons, university buildings, and other projects at an unsustainable rate.

When TABOR was triggered that spending spree came to a halt. Over the three years from 1997 to 2000, TABOR limited spending growth to inflation and population increases, generating more than $3 billion in surplus revenue that was used for taxpayer refunds, rebates, and tax cuts.

Efforts to Circumvent

One should not underestimate the ability of legislators to circumvent even the most stringent tax and spending limit. TABOR provided that state legislators, through referendum, could request voter approval to spend surplus revenue. One of the first responses of the legislature was to request approval to spend about half the TABOR surplus. That referendum was soundly defeated by the voters.

A more effective ploy for the spenders was to shift more revenue and expenditures off-budget. TABOR also exempted from the limit a state enterprise that received less than 10 percent of its revenue from the state. A number of state enterprises achieved that status, and the University of Colorado was the first state university to apply for enterprise status.

TABOR also requires voter approval for any increase in public debt. Politicians have circumvented that provision by issuing Certificates of Participation (COPs) through a separate government entity created with the power to issue debt for the construction of a building that is then leased to the government. Theoretically the government is not obligated to repay the debt, although in reality the debt becomes a government obligation.

One of the most egregious actions of the legislature to circumvent the constraints of TABOR has been the deferral of taxpayer rebates by one year. Instead of refunding surplus revenue in the year it is generated, the surplus is placed in the general fund, financing current spending; required refunds are financed from revenue generated in the following year. That scheme worked fine in the 1990s when revenues were growing rapidly; it is a recipe for disaster when the economy enters recession and revenues fall.

Perhaps the most dangerous attack on TABOR was launched by the teacher union in 2000. Through the initiative process, this special interest group enacted Amendment 23 to exempt spending for K-12 government schools from the TABOR limit. Under Amendment 23 the state must maintain a constant rate of growth in spending for education K-12 each year. (This resembles action taken in 1988 by the California Teachers Association to corrupt the California TEL—the Gann Limit—through Proposition 98.)

"State spending for K-12 education ... has increased more than 12 percent above inflation and enrollment growth during the past four years, now comprising more than 41 percent of the general fund budget."

Amendment 23 requires the state to earmark a share of state income tax revenue for an Education Trust Fund. State spending for K-12 education, now mandated by Amendment 23, has increased more than 12 percent above inflation and enrollment growth during the past four years, now comprising more than 41 percent of the general fund budget.

TABOR at Risk

In the current recession the Colorado economy has gone from one of the nation's success stories to a relative basket case. Booms and busts have occurred throughout the state's history. Today those booms and busts are tied not to natural resource industries, as in

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the past, but rather to industries of the new economy, such as telecommunications and high-technology industries, which have flourished in Colorado. This volatility in the state economy has wreaked havoc with state and local finance.

One explanation for Colorado government's fiscal crisis is changes in tax policy. The progressivity built into the income tax, despite the adoption of a flat rate income tax, means income tax revenues fall more rapidly than the decline in personal income. The increased share of state revenues generated by the income tax has increased its volatility vis-á-vis state revenues. Recent tax cuts have reduced the income tax rate to 4.63 percent; further reductions in the rate, to between 4.00 and 4.25 percent, would be required to return that tax to complete revenue-neutrality.

Another explanation for Colorado's fiscal crisis has been the overlay of the various constitutional provisions, in addition to TABOR, which control the fiscal outcome: property tax controls, Amendment 23's school mandates, the statutory spending cap, etc. Also, the ratcheting down requirements of TABOR for both property taxes, during a time of falling assessed values, and of the state tax and spending limit, during a time of declining revenues, has exacerbated the recession effects on government resources. All of this has stirred some big-spending Coloradans to claim TABOR is to blame and to call for its complete repeal.

TABOR Reforms

To head off such a calamity, TEL experts and proponents have been debating various reforms and improvements of TABOR to prevent what are considered by some to be harsh—and inappropriate—outcomes. Among the suggested reforms:

■ *Eliminate the "ratchet-back" effect*. Under TABOR, when revenues decline, the spending limit falls in tandem so that the level of government spending starts anew from a lower base when the recession is over and economic recovery begins. Many tax limitation proponents prefer this approach and outcome. But it opens the TEL to unnecessary criticism and risk.

An alternative that would work for both state and local governments would be to maintain the spending limit at the previous year's level throughout a recession, allowing it to increase only when revenues equal or exceed the spending limit. During this period, the decline in actual revenues would be offset by funds from the budget stabilization fund (see discussion below). This approach would prevent big spenders from calling for tax increases to fill in the "revenue gap."

■ *Establish a budget stabilization fund*. In periods of rapid growth, when the state is generating surplus revenue above the revenue limit, a portion of the surplus revenue could be allocated to a budget stabilization fund, with the rest allocated to tax cuts and tax refunds. When the economy enters a recession, funds would be transferred automatically from the budget stabilization fund to the general fund to offset revenue shortfalls.

■ *Establish a true emergency fund*. In addition to the budget stabilization fund, and entirely separate from it, would be a fund to meet natural and other non-economic disasters when declared by the governor and agreed to by a supermajority of the legislature. Expenditures from the emergency fund would require an appropriation. Replenishment of the fund would be a top budget priority.

Next month: Lessons from 30 years of TEL experience

Lew Uhler, president of the National Tax Limitation Committee, chaired then-Governor Ronald Reagan's Tax Reduction Task Force that developed Proposition 1. Uhler has remained active in the TEL movement nationally. Dr. Barry Poulson is a senior fellow in economic policy with the Independence Institute and professor of economics at the University of Colorado.

Wisconsin Needs a Taxpayer's Bill of Rights

by Hon. Frank Lasee

Although most policy analysts acknowledge weaknesses in Colorado's tax and expenditure limitation—the Taxpayer Bill of Rights (TABOR) adopted in 1992—the measure remains the country's leading model for how to structurally require a state to keep its fiscal house in order. Wisconsin needs something similar.

State spending grew at nearly twice the rate of population plus inflation between 1992 and 2002. Tax-spending special interest groups have tremendous influence in Madison—far more influence than is wielded by the tax-paying public. A TABOR would help defend the taxpayers' interest by shoring up the state's structural defenses against big spenders.

If TABOR had been in effect since 1992, Wisconsin taxpayers would have saved more than $1.5 billion in 2003 alone. That's a one-year savings of $276 for every man, woman, and child in the state—more than $1,000 back in the pockets of the average Wisconsin household. Imagine the spending power that would mean for a family, and the investments that could be made with that money!

A two-thirds majority vote of the state legislature would be required before the budget stabilization fund could be used, and it must be replenished at a rate of 1 percent per year.

TABOR Defense Strategy

TABOR offers a five-part strategy for defending taxpayers and restraining state spending:

■ Limit spending growth for the state and schools to the rate of growth in the state's population plus growth in inflation. In Wisconsin in 2003, this would have limited spending growth to under 4 percent, since the state's population increased 0.7 percent and inflation rose 3.1 percent.

■ Similarly, the growth in spending by counties and municipalities would be restricted to inflation plus local growth. This would be calculated using the same growth in inflation as at the state level, but adjustments would be made for the faster-growing local areas. A locality with faster economic growth would be able to have a higher spending limit, since its economy would be able to support it.

■ Any increase in income, sales, franchise, or property tax rates, at the state or local level, would require the approval of voters in a referendum. Those referenda could be held only on specific dates—regular election dates. Spending proponents would not be permitted to "sneak in" a referendum at an unusual time, when they can count on voter turnout to be low.

■ Similarly, any proposal by the state or local governments to borrow money would require the approval of taxpayers in a referendum vote.

■ Establish an emergency fund and budget stabilization fund. State and local governments would be required to establish an emergency fund equal to 3 percent of their annual expenditures, and a budget stabilization fund equal to between 4 and 15 percent of annual expenditures.

A two-thirds majority vote of the state legislature would be required before the budget stabilization fund could be used, and it must be replenished at a rate of 1 percent per year.

After the emergency and budget stabilization funds are established, any revenues the government body raises in excess of permitted spending must be refunded to taxpayers.

TABOR would allow spending limits to be exceeded in case of emergency. A two-thirds majority vote in each house of the state legislature (or local school board, county board, etc.) would be required to declare an emergency, and another two-thirds majority vote would be required in each house to approve a specific tax hike to address the emergency. Emergency spending could be approved only after all the existing rainy day funds (emergency and budget stabilization) are exhausted, and any unused funds collected for the emergency must be refunded to taxpayers if not used within 180 days.

Republican Frank Lasee represents the 2nd Assembly District of Wisconsin. His email address is **Rep.Lasee @legis.state.wi.us**. *He introduced TABOR legislation as Assembly Joint Resolution 55 on November 5, 2003.*

INTERNET INFO

Frank Lasee's TABOR legislation for Wisconsin is available on the Internet at **http://www.legis.state.wi.us/assembly/asm02/news/tabor.html**.

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Cook County Board Considers Compromise to Cut Spending

by John Skorburg

On December 15, a respected Chicago civic institution offered the Cook County (Illinois) Board of Commissioners advice on how to balance its fiscal 2004 budget with spending cuts, not tax hikes. Several key commissioners agreed and may force the Board to cut spending from the projected $2.9 billion budget.

"We call on Cook County officials to balance their budget without raising taxes," said Civic Federation President Laurence Msall. "There are many other ways the county's budget can be balanced without layoffs or service cuts.

"Although a vote on the county's fiscal 2004 $2.9 billion budget was postponed," Msall continued, "commissioners continue to discuss unnecessary tax increases. The Civic Federation has maintained that county officials could balance the budget with a number of alternative strategies."

County Board President John Stroger's proposal to increase the local sales tax was stalemated in November, and Commissioner Roberto Maldonado has offered a cigarette tax hike as an alternative. That proposal has not been warmly received, and many commissioners appear ready to push spending restraints instead.

The county's current cigarette tax is 18 cents a pack; Maldonado, with Stroger's support, has proposed raising it by 82 cents. Opponents of the increase say it would drive smokers out of the county to purchase their cigarettes.

With the current county tax, plus the state tax of 98 cents and the city tax of 16 cents, the per-pack price for many popular brands of cigarettes in Chicago is $4.83. Maldonado's increase would push that to $5.65. In nearby Hammond, Indiana, the same pack of cigarettes sells for $3.53 on average.

Cost-Cutting Strategies

On December 31, County Commissioner Earlean Collins released an alternative strategy for balancing the county budget by cutting costs, not increasing taxes. Collins explained to the *Chicago Sun-Times* that too much spending, not too little revenue, is the source of the county's budget problem. "Over the past four years," Collins noted, "revenue has exceeded projections by 2 percent. There is no reason to believe this trend will not continue, meaning $120 million more in revenue will be available in fiscal year 2004 than expected."

In a year-end report to commissioners, Collins suggested freezing general fund appropriations at the 2003 level with the exception of the Bureau of Health and the Board of Elections; eliminating all non-essential job positions that have been vacant for at least a year; and reducing the corporate fund balance from 9 percent to 5 percent. "If they balance the budget without [a tax increase], you've got my vote and this proves it can be done," Collins said.

Collins' approach should meet with the Civic Federation's approval. In the analysis and recommendations it released on November 19, the group offered the following specific ways to "improve Cook County's revenue stream and financial management."

- Stroger should use the budget authority he already possesses as County President to control spending, including spending by other elected officials.
- County officials should implement recommendations contained in the 2001 County Operations Review Team (CORT) report. The report presented 117 recommendations identifying as much as $129 million in savings. Most of those recommendations have not been implemented to date.
- The County should eliminate automatic "step" wage increases for employees, who also receive annual cost of living increases. The step increase costs $26 million a year.
- The County should pursue joint purchasing of health insurance with other local governments, which could result in annual savings of as much as $22.5 million. Employee co-payments for doctor visits should be increased from $3 to $10 a visit, saving the County as much as $7.5 million annually.
- Janitorial services should be removed from the jurisdiction of the Sheriff's office and outsourced, for annual savings of as much as $5 million.

"While Cook County faces a short-term problem in eliminating an $86 million deficit in 2004, it faces a much bigger long-term problem: How to make Cook County government operate more efficiently," said Msall. "There is no shortage of long-term cost-cutting ideas from civic organizations and the county's own research reports. Most of these recommendations have yet to be acted upon.

"Cook County government must put its fiscal house in order," Msall insisted, "and imposing fiscal discipline and implementing management efficiencies should be the first line of attack. Only as a last resort should tax increases even be considered."

"I commend her [Collins] because she took a very courageous stand," said County Commissioner Mike Quigley. "He [Stroger] doesn't have the votes for his budget. He could veto our cost-cutting budget, and then we'd be staring at each other."

Stroger's spokeswoman, Caryn Stancik, said he is "reviewing Collins' proposals and plans to meet with her soon."

Collins, who said Stroger "has shown a more cooperative spirit" since she issued her proposal, denied feeling any pressure as a key vote. "I'm pressure-proof," she said.

State law says the budget must be passed by the end of February. No date has been set for a budget vote.

John Skorburg is managing editor of Budget & Tax News. *His email address is* **skorburg@heartland.org**.

Cigarette Tax Increases 2000 - 2004

State	Increase/ Pack	New Rate/Pack	Effective Date
Arizona	$0.58	$1.18	11/25/2002
Arkansas	$0.04	$0.34	7/1/2001
Connecticut	$0.61	$1.11	4/3/2002
Connecticut	$0.40	$1.51	3/15/2003
Delaware	$0.31	$0.55	8/1/2003
District of Columbia	$0.35	$1.00	1/1/2003
Georgia	$0.25	$0.37	7/1/2003
Hawaii	$0.20	$1.20	10/1/2002
Hawaii	$0.10	$1.30	7/1/2003
Hawaii	$0.10	$1.40	7/1/2004
Idaho	$0.29	$0.57	6/1/2003
Illinois	$0.40	$0.98	7/1/2002
Indiana	$0.40	$0.555	7/1/2002
Kansas	$0.46	$0.70	7/1/2002
Kansas	$0.09	$0.79	7/1/2003
Louisiana	$0.04	$0.24	8/1/2000
Louisiana	$0.12	$0.36	8/1/2002
Maine	$0.26	$1.00	6/1/2001
Maryland	$0.34	$1.00	7/1/2002
Massachusetts	$0.75	$1.51	7/25/2002
Michigan	$0.50	$1.25	8/1/2002
Montana	$0.52	$0.70	5/1/2003
Nebraska	$0.30	$0.64	10/1/2002
New Jersey	$0.70	$1.50	7/1/2002
New Jersey	$0.55	$2.05	7/1/2003
New Mexico	$0.70	$0.91	7/1/2003
New York City	$1.42	$1.50	7/2/2002
New York State	$0.55	$1.11	3/1/2000
New York State	$0.39	$1.50	4/3/2002
Ohio	$0.31	$0.55	7/1/2002
Oregon	$0.60	$1.28	11/1/2002
Pennsylvania	$0.69	$1.00	7/15/2002
Pennsylvania	$0.35	$1.35	1/1/2004
Rhode Island	$0.32	$1.32	5/1/2002
South Dakota	$0.20	$0.53	3/18/2003
Tennessee	$0.07	$0.20	7/15/2002
Utah	$0.18	$0.695	5/6/2002
Vermont	$0.49	$0.93	7/1/2002
Vermont	$0.26	$1.19	7/1/2003
Washington	$0.60	$1.424	1/1/2002
West Virginia	$0.38	$0.55	5/1/2003
Wisconsin	$0.18	$0.77	10/1/2001
Wyoming	$0.48	$0.60	7/1/2003
U.S. Median		$0.59	7/1/2003

Compiled by *Budget & Tax News* from various government sources.

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Slovakia

Continued from page 1

the Slovak Parliament approved the law on the old-age pension savings scheme," wrote Ludoviit Kaniik, Minister of Labor and Social Affairs. "Thus, as of 1 January 2005, Slovak workers will start depositing 9% into their personal savings accounts."

"American workers deserve the same security, control, and wealth-building opportunity as Slovakians," asserted a CSE statement that accompanied the release of Kaniik's letter. "Tell Congress to get moving!"

Private Accounts Worldwide

According to Amy K. Frantz, a research analyst with the Public Interest Institute at Iowa Wesleyan College, "Since Chile's adoption of a private retirement system, many other countries have followed, implementing plans to partially or fully privatize their own social security retirement systems."

Frantz reports the following countries also have successfully privatized:

- **Great Britain**–allowed firms with their own pension programs to start opting out of the government-run social security system as early as 1978. By 1988, the Thatcher administration had enacted a personal account option. About 80 percent of British workers have opted out of the government-run system and into a private alternative system.
- **Mexico**–in 1997, adopted a personal account option for all beneficiaries under the country's retirement system.
- **Hungary**–on January 1, 1998, Hungarian workers began paying into personal accounts for their retirement benefits, replacing the bulk of the government-run retirement system.
- **Kazakhstan**–this former Soviet Republic adopted a system similar to Hungary's in 1998 as well.

Even China is making strides in pension privatization. "This Communist country has already adopted a personal account system for urban workers and is developing plans to extend the accounts to the entire country," notes Frantz.

Australia also has had a private retirement system for many years. "Australia has a strong and effective retirement system, providing detailed and comprehensive retirement accounts for individuals who wish to retire with dignity and economic security," said David Harris, a native of Australia and research associate with Watson Wyatt Worldwide when he addressed The Heritage Foundation in May 1998.

U.S. Behind the Curve

The need for similar reform is strong in the United States. The Social Security Reform Center Web site, affiliated with the Citizens for a Sound Economy Foundation, points out, "Public concern is well grounded; studies and official reports confirm that Social Security cannot be sustained in its current form and, even if its revenue and expenditures were in long-term balance, it is providing poorer and poorer retirement income security for the money contributed by today's workers."

Piñera, who is co-chairman of the Cato Institute's Project on Social Security Choice and former secretary of labor and social security for Chile, has been advocating the privatization of social security systems for more than a decade, worldwide and in the U.S.

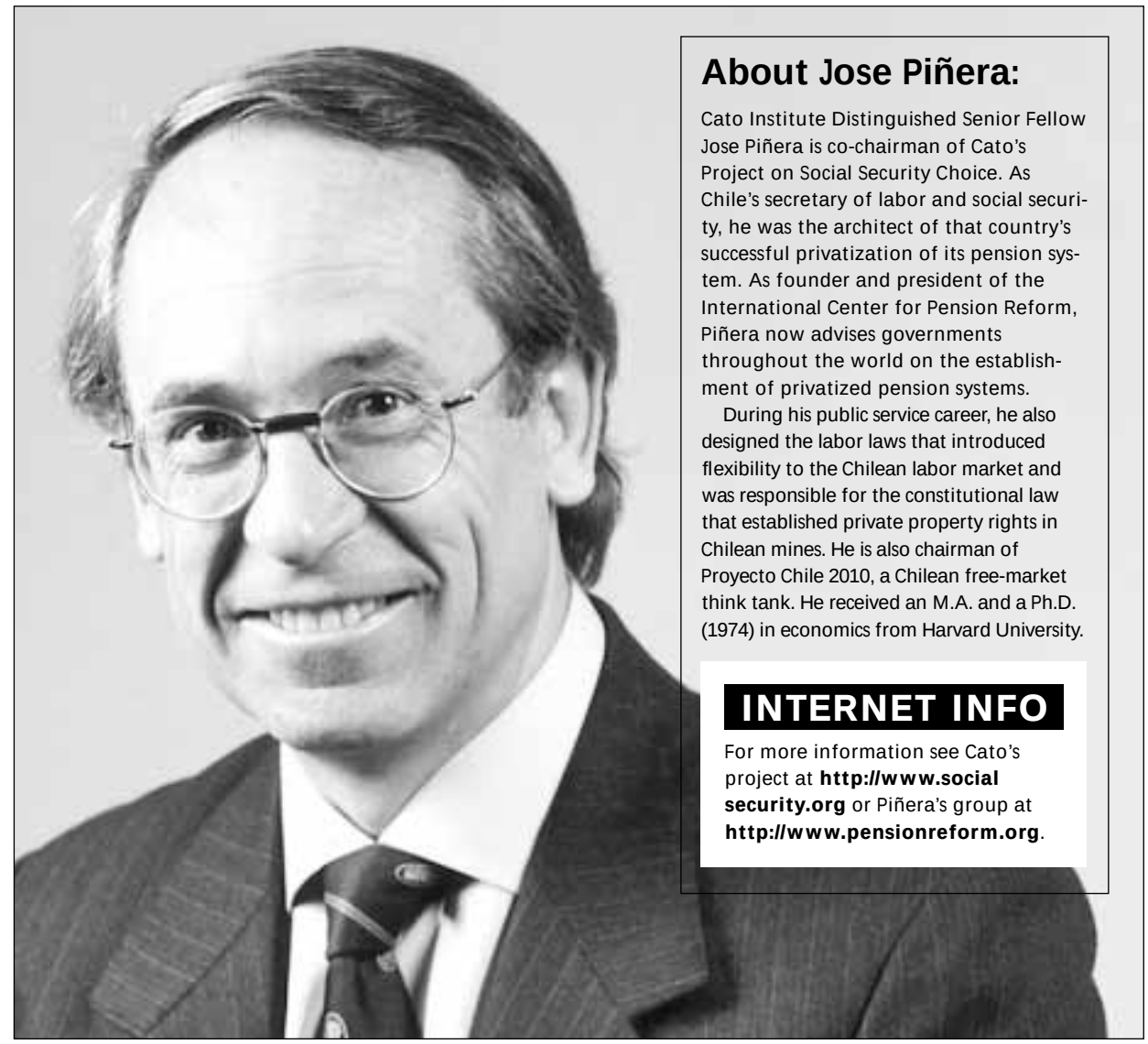
"It is a fact that the United States Social Security system, like the Titanic, is heading toward disaster," said Piñera. "If the ship doesn't change course, sooner or later you're going to hit an iceberg: an aging population that cannot be supported by the workforce. The truth is that there are only two options: to prolong the agony of the current system, or to take the bull by the horns and move towards personal retirement accounts.

"When I became Labor and Social Security Secretary of Chile in 1978," said Piñera, "my country faced the same problem the U.S. now confronts. We decided to save our social security system by giving every worker the choice to move from a pay-as-you-go model to one of personal retirement accounts.

"Workers now choose among competing private companies to invest the equivalent of what used to be their payroll taxes in a conservative portfolio of high-rated bonds and equities," Piñera explained. "This allows workers to harness the powerful force of compound interest—reflecting the wealth-creating effect of the market—to ensure their security in retirement.

"The main winners [of social security reform] are the poor, not the rich," said Piñera. "High-wage earners can always save for their own retirement. But medium and lower-income workers don't have spare cash to save in separate individual retirement accounts; they suffer the most with negligible returns on their Social Security payments. They will gain the most from a system that allows them to invest their payroll taxes in real assets."

John Skorburg is managing editor of Budget & Tax News. *His email address is* **skorburg@heartland.org**.



About Jose Piñera:

Cato Institute Distinguished Senior Fellow Jose Piñera is co-chairman of Cato's Project on Social Security Choice. As Chile's secretary of labor and social security, he was the architect of that country's successful privatization of its pension system. As founder and president of the International Center for Pension Reform, Piñera now advises governments throughout the world on the establishment of privatized pension systems.

During his public service career, he also designed the labor laws that introduced flexibility to the Chilean labor market and was responsible for the constitutional law that established private property rights in Chilean mines. He is also chairman of Proyecto Chile 2010, a Chilean free-market think tank. He received an M.A. and a Ph.D. (1974) in economics from Harvard University.

INTERNET INFO

For more information see Cato's project at **http://www.socialsecurity.org** or Piñera's group at **http://www.pensionreform.org**.

"Your visit to Slovakia started an intense discussion about the pension reform"

Dear Mr. Piñera,

Please allow me to convey to you my warmest greetings and thanks for your precious time during our visit to Chile. At the same time I would like to share some good news with you. On Tuesday, the 16th December 2003, the Slovak Parliament approved the law on the old-age pension savings scheme. Thus, as of 1 January 2005, Slovak workers will start depositing 9% into their personal savings accounts. These savings will be their private property, to which succession rights will fully apply.

I am confident that the pension reform, borne by your inspiration and with your significant assistance, will bring not only higher pension to our citizens but also freedom and self-assurance while seeking out the correct way.

Your visit to Slovakia started an intense discussion about the pension reform and enormously influenced the generation of a favourable political climate. I am very happy that this issue did not remain at a conception level but that we could prepare as well as assert the legislation preconditioning the pension reform. The time of our visit to Chile coincided with the period of acute search for parliamentary support of the main law of the reform.

The discussion with you made great impression, and contributed to a major extent to the determination and will of the members of our parliament to push through this historically new project of the pension system in our society. I am thankful as well as obliged to you for your efforts that resulted in very good news not only for our citizens but to people all over the world as well.

Please accept my best wishes for Christmas and a Happy New Year.

Respectfully,

Ludovíit Kaníik
Minister of Labor and Social Affairs

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Boston Mayor Advocates Property Tax Shift

Philip Greenspun

Boston Mayor Thomas M. Menino

by John Skorburg

At a December 30 meeting of a special legislative commission on property taxes, Boston Mayor Thomas M. Menino advocated a plan for a temporary shift of the local property tax burden, from residential to commercial property tax payers.

The state legislature in 2003 had ordered the five-member commission to draft a bill by January 12 that would allow communities to raise commercial property tax rates beyond the current limits and phase out the increase in four years.

According to the *Boston Globe*, Menino's proposal to make businesses pay a higher property tax rate is "splintering the state's business community, with real estate heavyweights endorsing the idea and small business owners complaining that they will be disproportionately burdened." Bill Vernon, state director of the National Federation of Independent Business, said "the property tax proposal will hit neighborhood barber shops, pizza parlors, and convenience stores the hardest and lead to a loss of jobs.

"You can't increase property taxes on 30,000 to 40,000 businesses in the state of Massachusetts—it won't work," said Vernon, whose group represents smaller enterprises.

Homeowners Want Relief

According to the *Globe*, the proposal would shield homeowners from an average tax increase of 40 percent for single-family houses in 2004. Amalia Barreda of Channel 5 television reported that from the "toniest townhouses on Beacon Hill to the working class three-deckers in South Boston, homeowners are protesting their latest property tax bills."

City Council member Jim Kelly said his phones are ringing off the hook. "A lot of people that it's affecting are long-time residents. Many of them are living on a fixed income," Kelly said.

Channel 5 noted that "while residential property values have skyrocketed, commercial property values have not." That is why Menino considered his proposal necessary only in the short term.

> **"The property tax proposal will hit neighborhood barber shops, pizza parlors, and convenience stores the hardest and lead to a loss of jobs."**
>
> BILL VERNON
> NATIONAL FEDERATION OF
> INDEPENDENT BUSINESS

"We think it's an anomaly. We don't think it will ever happen again. All our tax experts and our economists, advisors, on this legislation said it probably won't happen again," Menino said.

Drag on the Economy

Reported Barreda, "Commercial property owners do not like the mayor's solution one bit. Small, neighborhood businesses who say they are already struggling to survive claim that they especially would be taking an unfair hit."

"It certainly puts a huge drag on the growth and jobs in this state, which are things everybody wants," Vernon said.

According to the *Globe*, city officials have noted that even if Menino's proposal passes, many business owners whose properties are depreciating in value will pay less in property taxes next year than they did this year, though the mayor's measure would mean their taxes would not fall quite as much. Several of the city's most prominent business owners say they are willing to accept that deal for the good of the city.

"For us to have a 15 to 20 percent drop with residential properties going up 40 percent is just the wrong message at the wrong time," said Robert L. Beal of the Beal Companies, which owns residential and commercial properties in Greater Boston. Beal lives on Beacon Hill, one of Boston's luxury neighborhoods.

But the owners of smaller storefronts will see increases, not decreases, if Menino's measure passes. "Commercial property is valued on the income—if you have an office tower and 25 percent of the space is vacant, your valuation will go down," said Eileen McAnneny of Associated Industries of Massachusetts, which has lobbied heavily against Menino's measure. "That isn't true for the gas station on the corner, or some of the other commercial properties in neighborhoods."

Won't Solve the Problem

Jeff Ciuffreda, vice president of the Affiliated Chambers of Commerce of Greater Springfield, said his group is "sympathetic to the situation that Boston and a few of the other cities find themselves in." But Ciuffreda said he doubts the proposal will "solve the broader problem of diverging residential and commercial values."

Menino's proposal would change the Classification Law, a 1978 amendment to the state constitution that allows cities and towns to set different tax rates for residential and commercial property. The law presumes business owners are "better able to handle" tax increases than homeowners, who may be on fixed incomes. Under the law, the residential rate cannot be less than 50 percent of what it would be if the city did not distinguish between residential and commercial properties, and the commercial rate cannot be higher than 175 percent of what the rate would be without classification.

An unusual divergence between rapidly rising residential property values and stagnant commercial ones has created the problem. Boston and nearly 50 other cities are reaching the 175 percent limit. Menino and other mayors want the limit raised to 200 percent.

"On its face, it purports to be a short-term proposal but in this [government] building when one raises taxes very rarely does one see those taxes go down," Massachusetts Taxpayers Foundation spokesman Michael Widmer said. "We're told by the mayor it does end, and it's only going to be a temporary fix. But what if it's not?"

John Skorburg is managing editor of Budget & Tax News. *His email address is* **skorburg@heartalnd.org**.

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Oakland Mayor Floats Sin Taxes on Junk Food and Drinking

by John Skorburg

Oakland, California Mayor Jerry Brown has recommended the state solve its budget woes by exploiting residents' bad habits, by taxing behaviors such as drinking and eating junk food.

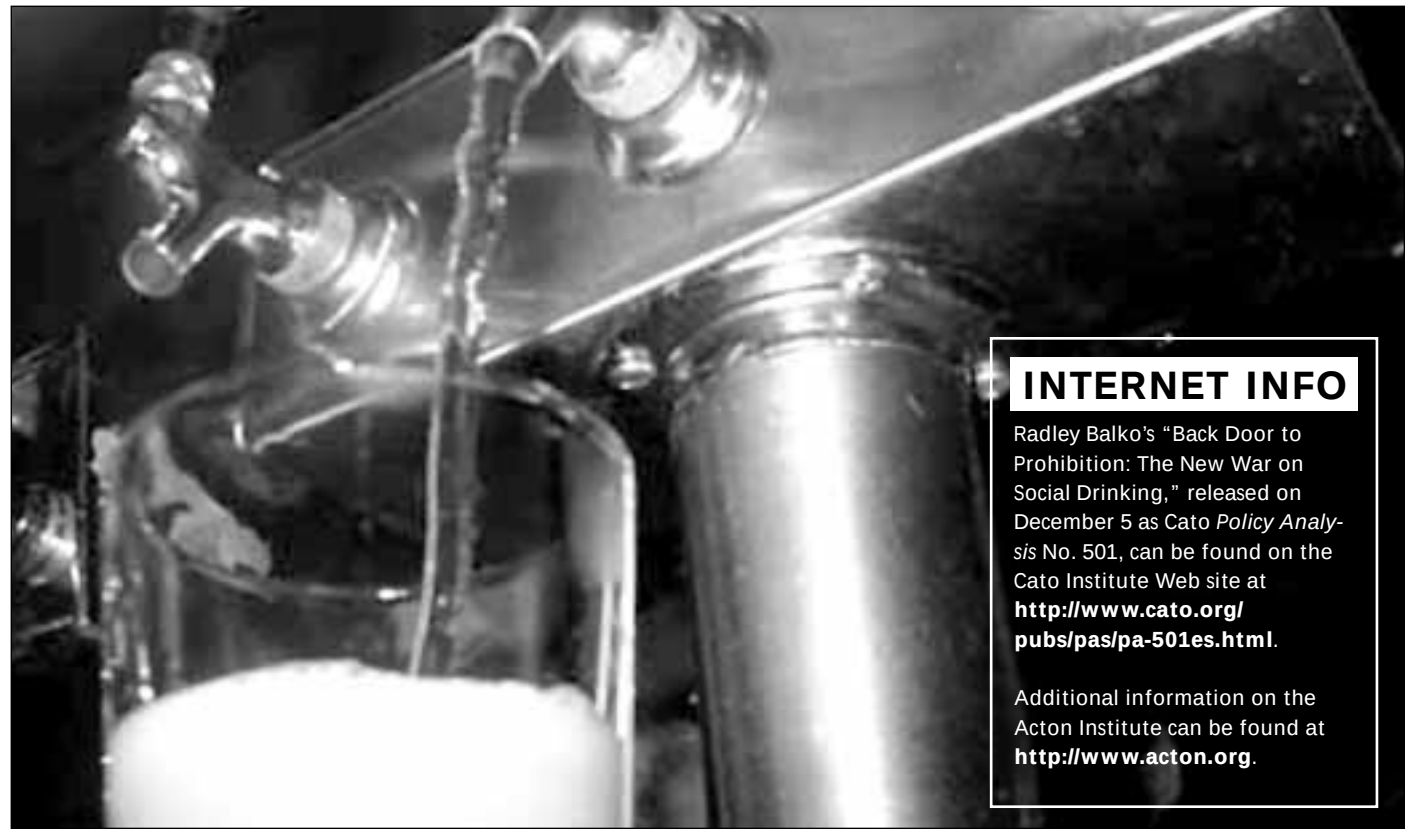
In an interview published on December 20, Brown told the *San Mateo Daily Journal* "there are a number of activities" that could be taxed and suggested a tax on people who eat salty and sugary foods as well as "a tippler tax on those who drink at the bar." Brown's spokeswoman, T.T. Nhu, said the mayor has been influenced by policies in Canada, which "taxes chocolate in addition to alcohol and cigarettes."

Radley Balko, a tax policy analyst at the Washington, DC-based Cato Institute, expressed surprise at the honesty of Brown's approach.

"Politicians usually say the reason they want to impose sin taxes is to stop unhealthy behavior. I've never before heard an elected official say that the real purpose is to raise money. That's a novel approach," Balko said.

"Sin taxes do generate revenue, and I question the sincerity of government officials who say their real priority is stopping the behavior they're taxing," noted Balko. "Sin taxes usually are proposed only when governments face large budget shortfalls.

"In the case of tobacco taxes," Balko explained, "state and local governments have become addicted to the revenue they generate and would take a financial hit if fewer people smoked."



INTERNET INFO

Radley Balko's "Back Door to Prohibition: The New War on Social Drinking," released on December 5 as Cato *Policy Analysis* No. 501, can be found on the Cato Institute Web site at **http://www.cato.org/pubs/pas/pa-501es.html**.

Additional information on the Acton Institute can be found at **http://www.acton.org**.

Resisting Temptation

Rev. Robert A. Sirico, president and cofounder of the Acton Institute for the Study of Religion and Liberty, agreed. "The search for government revenue in fiscally tight times tempts legislators to raise revenue by imposing unusually high excise taxes on cigarettes, liquor, gambling, and so on. This type of charge appeals to voters who view it as a way of discouraging consumption of certain objectionable products. Yet the temptation to impose sin taxes is one that should be resisted for economic and moral reasons."

In an essay posted on the Action Institute's Web site, Sirico added, "The consequences of the sin tax are often the very opposite of those intended by its designers. Rather than increasing revenue, the sin tax can reduce it. Rather than discouraging what are regarded as morally questionable behaviors, the sin tax can make them more appealing. Rather than reducing what are perceived to be internal costs of the sin, the sin tax can increase them and expand them to society as a whole."

Steep tax hikes "spur people to buy products on the black market instead of in retail stores," noted Balko. Because of high taxes, the bootleg cigarette market has thrived for decades in New York City, diverting millions of dollars from lawful businesspeople into the pockets of criminals and terrorist organizations, Balko said. "The same thing could happen in places where alcohol taxes are dramatically raised," he pointed out.

In a recent paper, "Back Door to Prohibition: The New War on Social Drinking," Balko said excise taxes unfairly force all drinkers to pay for the societal costs attributable to a small number of drinkers who abuse alcohol. Problem alcoholics are unlikely to stop drinking because of higher alcohol taxes, Balko noted, so low and middle-income social drinkers bear the brunt of the tax. Alcohol taxes are "incredibly regressive," Balko said, "falling disproportionately on the poor, as they spend a greater percentage of their income on alcohol."

Nhu said Brown's sin tax musings are "just an idea" for now. But she said Brown thinks "higher taxes in some form are needed" to put the state's financial house in order, even though Governor Arnold Schwarzenegger believes the state's problems are caused by "overspending and not under-taxation."

On January 6, the governor said in his first major address of 2004, "We have no choice but to cut spending, which is what caused the crisis in the first place. If we continue spending and don't make cuts, California will be bankrupt."

Sirico, also a full-time parish priest, warned the sin tax debate has implications that go well beyond California's current budget situation. "Before we empower the government with what are, effectively, pastoral responsibilities," Sirico recommend, "we ought to consider fundamental issues regarding the interplay between private morality and public policy."

John Skorburg is managing editor of Budget & Tax News. *His email address is* **skorburg@heartland.org**.

Temporary Sales Tax Petition Falters in Missouri

by John Skorburg

According to a recent Associated Press report from Jefferson City, Missouri, "supporters of a tough-times tax proposal have abandoned efforts to get it on the August 2004 ballot, citing a lack of both public support and campaign cash."

The proposal for a temporary state sales tax had been approved for petition circulation, but supporters said in late December "they would not even try to gather the signatures needed to qualify the measure for the ballot."

"The polling has showed that early on it was better received than it currently is," said lobbyist Doug Burnett, a member of The Policy Group, a consulting firm formed recently by six state capitol lobbyists. "If the polling numbers aren't adequate, it would be extremely difficult to raise the funds needed for a campaign."

Burnett said about "65 percent of the respondents to a public opinion poll conducted last July indicated they were likely to vote for the proposal." But in a poll conducted in December, that figure fell to "around 50 percent." Making matters more difficult, Burnett said, was "a very short window" requiring that petition signatures be submitted before February 3 if the measure was to be approved for the August ballot.

The group did not want the measure to appear on "next November's ballot, where it could have been overshadowed by elections for President, governor, and other top state offices."

According to the AP report, under the ballot proposal, the "state commissioner of administration would have determined by each September whether the state's net general revenues, on a per-capita basis, had fallen below the revenue level of the 2001 fiscal year, when adjusted for inflation." If so, the state would have been deemed to be in a "fiscal emergency" and sales taxes automatically would have risen by up to 1 percent, or by whatever lesser amount was determined by the commissioner to be sufficient to make up the shortfall.

The temporary tax increase could have been stopped only by a two-thirds vote of the legislature. Money raised by the automatic tax increase would have been earmarked for education and health care.

To make the ballot, supporters would have needed valid signatures from registered voters equal to 8 percent of the total votes cast in the 2000 gubernatorial election from six of the state's nine congressional districts. Depending on the districts targeted, the number of required signatures would have ranged from 123,000 to 128,000.

Lobbyist Burnett said that although The Policy Group is dropping its ballot initiative, it is "not disbanding and may champion other issues in the future."

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Spending Our Future Tax Cuts?

Congress is on a spending spree that will result in higher taxes

by Dick Armey

Not too long ago, conservative lawmakers talked about enacting new tax cuts each and every year of the Bush administration. The White House has been led by a President who fought for the second largest tax cut in history ... and then came back and enacted the third largest tax reduction. We had hope for continued tax reform and lower tax burdens on all working Americans.

Today that bright future of less government, lower taxes, and more freedom is threatened by an uncontrolled congressional spending spree. At some point—and we are not far from it—the spending increases threaten the viability of future tax cuts. We cannot continue massive expansions in farm subsidies, the largest expansion of federal education spending since the Great Society, and congressional appropriators increasing spending on each area of government pork each year and still make the case for tax cuts.

We cannot add the largest expansion of Medicare spending ever in the form of a prescription drug benefit, without any financial reforms, and expect to use new tax cuts to grow our way out of deficit spending. And this is especially true in a time of war, when large increases in military spending are needed to meet the federal government's primary constitutional responsibility: to provide for the common defense.

I have spent a great deal of time in politics and I understand the temptations to make short-term compromises. I understand that it is almost always easier to win friends by using the federal treasury than standing for the principles of limited government. As a political matter, the Medicare legislation passed by the Republican Congress provides a short-term benefit over the hapless Democrat party. The Republican majority took away an issue the Democrats are supposed to own. But the long-term consequences are too high a price to pay.

The Medicare issue was not won by the hard work and admittedly risky path of making the case for fundamental Medicare reform. An argument was not made for market forces, competition, and financial sustainability. Instead, the issue was won by generating a majority vote for a huge new entitlement expansion.

So much remains uncompleted on tax reduction. The Death Tax remains with us, which punishes savings and investment. Capital gains tax rates are too high for international competitiveness. Investors are still punished with the double taxation of dividends. Fundamental tax reform for all taxpayers is left unfinished. Liberals oppose these common-sense ideas. The arguments get harder for conservatives while government spending continues to explode.

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HON. DICK ARMEY

The short-term spending "victories" threaten the long-term argument between conservatives and liberals. In the long run, if America wants lower taxes, America must have limited government. I believe there are already fewer votes in the Republican majority for a 2004 tax cut than there were before the Medicare expansion passed. There are fewer Republican tax-cutters than there were before the education expansion and the farm subsidy expansion. And in the long run, that is a very heavy price to pay for a short-term tactical victory.

There has been little semblance of fiscal discipline since 9/11. After the 2001 terror attacks, Congress rightly appropriated virtually unlimited sums for military action and homeland defense, but afterward, the Republican majority allowed the infection to spread through the entire budget. We must find a way to stop it—and stop it very soon.

*For 18 years in the House of Representatives, Dick Armey fought for lower taxes, less government, and more freedom. He joined Citizens for a Sound Economy (***http://www.cse.org***) in 2003 as its co-chairman.*

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Growing

Continued from page 1

tivity—all point to a recovering and resurging economy in the U.S."

State Revenues Lag Economic Growth

"Surely this will be good news for state budgets that have recently been awash with red ink. Good economic news almost surely will improve state government finances," said Dan Mitchell, McKenna Senior Fellow in Political Economy at The Heritage Foundation.

Tax revenue growth, however, typically lags behind economic growth. The third quarter's 8.3 percent increase in GDP will not immediately result in an increase of 8.3 percent in tax revenues. It takes time for higher economic growth to translate into higher state tax revenues and "healthier" state budgets.

Some tax revenue sources will track economic growth more closely than others, however. "Sales taxes closely follow economic growth," said Chris Edwards, a fiscal policy analyst at the Cato Institute. Other state taxes, like those levied on personal and corporate income, take longer to reflect improved economic growth.

States are already experiencing more robust overall revenue growth. Numerous states have reported revenue growth ahead of expectations in recent weeks and months, and groups like the National Governors Association do not expect budget deficits to be as severe in 2004 as they were in 2003.

Watch State Spending

Nevertheless, policy analysts are reluctant to say states will quickly rebound. "The economic indicators are both good news and bad news," explained Mitchell. "The good news is that it makes tax increases less likely. The bad news is that it makes budgetary discipline less likely."

Edwards agreed, noting that a recovering economy "will reduce political will to streamline services."

State spending data maintained by the National Association of State Budget Officers (NASBO) confirm the fears of both analysts. State spending grows at a lower rate in poor fiscal times (like the recessions of the early 1980s and 1990s) than in booming fiscal times (like the mid- to late 1980s and 1990s). State spending bottomed out at 0.7 percent real growth in 1991, in the midst of a recession, and peaked at 5.2 percent real growth rate in 1999, a year of strong economic growth.

Taxes May Hurt Economic Growth

Even with a growing economy, state tax increases are not completely "off the table" in 2004. Alabama, Kansas, Oregon, Pennsylvania, and Virginia are currently considering tax increases, which experts warn could blunt the economic recovery in those states.

"Numerous econometric studies have established a strong correlation between higher taxes and lower economic growth," said John Berthoud, president of the National Taxpayers Union.

Tom Hinton, director of state relations at The Heritage Foundation, said "there will always be pressure to increase taxes as long as state shortfalls exist. Thankfully, it is easy to see what states do a better job, as we watch business and people move in or out. California's mass exodus of people [and] companies is a prime example."

In most states, lawmakers will find it difficult to balance their budgets next year and beyond—even with a recovering economy, avoidance of growth-busting tax increases, and a commitment to spending restraint. "States will need to implement permanent reforms to keep budget growth under control," said Berthoud.

Texas offers one example of a state committed to structural reform. Lawmakers in the Lone Star State reorganized the state's health care delivery system in 2003, saving the state a projected $1 billion a year—without a serious reduction in health care services delivered to its citizens.

Policy Recommendations

Edwards has identified several structural reforms state lawmakers can adopt during times of economic expansion, making it easier to weather times of economic retraction. He recommends, for example, that states adopt "sunset commissions," authorizing most state spending programs for only 10 years. By requiring that a program be periodically reauthorized, the sunset commission strategy helps ensure spending programs do not live on in perpetuity, regardless of their effectiveness.

Edwards is also concerned about transparency in state budgeting. "It's really tough for the average citizen to find out exactly how much his state is spending and how much spending has gone up," he noted, recommending states take steps to make historical trends in tax and spending more apparent to the voters, so they can hold lawmakers accountable.

Edwards would also like to see states revisit their corporate income taxes. "Smart states will repeal their corporate income taxes," he said. "They raise only 5 percent of total state revenues, are extremely complicated, and capital is so mobile that states cannot go after them."

Fiscal relations between the federal and state governments also need improving. According to data compiled by the federal Bureau of Economic Analysis, federal grants-in-aid to states in 2002 reached $304.6 billion—21.3 percent of total state receipts.

"By requiring that a program be periodically reauthorized, the sunset commission strategy helps ensure spending programs do not live on in perpetuity, regardless of their effectiveness."

A major threat to liberty and lower taxes in the long run, said Hinton, is "the drug of the federal dollar that keeps states in an addicted stupor." Some states receive as many as three federal dollars for each dollar they spend on such programs as Medicaid—which means a one-dollar cut in Medicaid spending actually results in a four-dollar cut. This often keeps bloated federal-state spending programs off the chopping block when states are looking to pare spending.

NTU's Berthoud is concerned about overall federal spending—not only the grants-in-aid program—and the impact it could have on state recovery. "I worry that excessive federal spending by Congress and the Bush administration may ramp up pressure for federal tax hikes in the coming couple of years. Those tax hikes would have an adverse effect on state economies and budgets.

"State lawmakers should not be under any allusions that economic recovery will quickly end their fiscal problems," said Berthoud. "Lagging revenues, self-made problems, and even the fiscal relationship with the federal government will provide plenty of fiscal challenges in the years ahead."

Chris Atkins is director of tax and fiscal policy for the American Legislative Exchange Council and a contributing editor to Budget & Tax News. *He can be reached from the ALEC Web site at* **http://www.alec.org**.

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Former Senator, Friend of Taxpayer Dies

by John Skorburg

Former U.S. Senator William V. Roth Jr., a fighter for tax cuts and IRS reformer during his five terms in Congress and creator of the popular retirement account that bears his name, died on December 13. He was 82.

"Bill Roth was the epitome of public service in Delaware," said Governor Ruth Ann Minner in a statement issued the day of Roth's death. "His many years serving the people of Delaware earned him a place in their hearts that few politicians reach. Senator Roth's work in the areas of reducing taxes, balancing the federal budget, reforming government, leading foreign relations, and preserving the environment are well-known."

"It's a sad day for Delaware," said U.S. Senator Joseph Biden (D-Delaware). "This was one of the truly great figures in Delaware politics."

Roth, a Republican, co-authored the 1981 Kemp-Roth tax cuts, but he was best known as the creator of the Roth Individual Retirement Account, or Roth IRA.

In 1983, as chairman of the Senate Governmental Affairs Committee, he helped to expose wasteful defense spending, drawing attention to overpriced spare parts by decorating a Christmas tree with screws, nuts, and wrenches. The total price tag was $101,000. "It costs us $110 to buy the same parts at local hardware stores and supply houses," Roth said at the time.

Roth Remembered for Exposing IRS

IRS expert Dan Pilla recalled Roth's efforts to expose abuse at the Internal Revenue Service.

"The date was September 23, 1997. The United States Senate stood on the threshold of what would become three days of explosive testimony regarding the IRS, its attitudes and its often-abusive practices. In his opening remarks that morning, the late Senator William Roth, then the sitting chairman of the powerful Senate Finance Committee, provided a hint of the story that was about to unfold. It was the story of an agency with 'extraordinary powers,' one that had, frankly, gone out of control," remembered Pilla.

According to Pilla, Roth said at that time, "Over the course of the next three days we are going to see a picture of a troubled agency, one that is losing the confidence of the American people, and one that all too frequently acts as if it were above the law. This is unacceptable."

Given the strength of Roth's leadership on the Finance Committee, "the IRS soon found itself in the hot seat," noted Pilla. Committee members grilled high-ranking IRS officials on wide-ranging allegations of official misconduct, disregard of its own rules and procedures, even maleficence toward citizens.

"Rarely have Americans been so captivated by the goings-on in Washington," noted Pilla. "The nation watched with a great sense of satisfaction as the tables were finally turned on the IRS. Rather than the IRS causing fear and consternation in the lives of honest citizens, the agency found itself choking down the bitter taste of its own medicine.

"Never before had a sitting member of Congress shown the courage to bite the hand that feeds it," said Pilla. "After all, if not for the IRS, Congress would have no way to collect the hundreds of billions it spends so freely every year. And it is that very reason that for decades Congress left the IRS alone, viewing the agency as providing the only true 'return on investment' of any government organization or program."

Added Pilla, "The IRS was brazen and growing more so each year. Taxpayers were crying out for relief and there was a loud and growing movement to abolish the IRS and the income tax entirely. Something had to be done."

The abuse hearings led to historic legislation. The Internal Revenue Service Restructuring and Reform Act, passed on July 22, 1998, spelled out significant changes to the IRS and the way it does business. According to Pilla,

- The agency was reorganized into units that would focus only on select, pre-defined groups of taxpayers. This way, the employees of a given unit could be better educated on the nature of the businesses and citizens who comprised the group the employees were to handle.
- Congress added the "ten deadly sins" to the law. This is the list of actions that will lead to the termination of an IRS employee who commits one. Such actions include the violation of taxpayers' rights and the harassment of taxpayers.
- More independence and authority was granted the office of the Taxpayer Advocate. This is the official with the authority to stop the IRS from taking any action that causes a serious hardship to the citizen.
- Important appeals rights were added to the law so that collection actions, such as wage levies, tax liens, and bank levies, could be challenged, and collection alternatives could be proposed before the IRS pulled the trigger on these potentially damaging steps.
- Sweeping changes were made to the so-called "innocent spouse" laws so that more people could get relief from joint tax debts with a present or former spouse, if such debt was attributable to the other spouse.

Former Senator William V. Roth Jr.

"Roth's retirement from the Senate removed from Congress one of the precious few IRS watchdogs," said Pilla. "And because of its insatiable lust for other people's money," Congress is now about the business of dismantling many of the protections that were ushered in by the Restructuring Act.

"I see the IRS steadily returning to the kind of agency it was prior to the time when Chairman Roth declared that its actions were unacceptable," noted Pilla. "Unfortunately, Chairman Roth is no longer in the Senate to halt the trend."

John Skorburg is managing editor of Budget & Tax News. *His email address is* **skorburg@heartland.org**.

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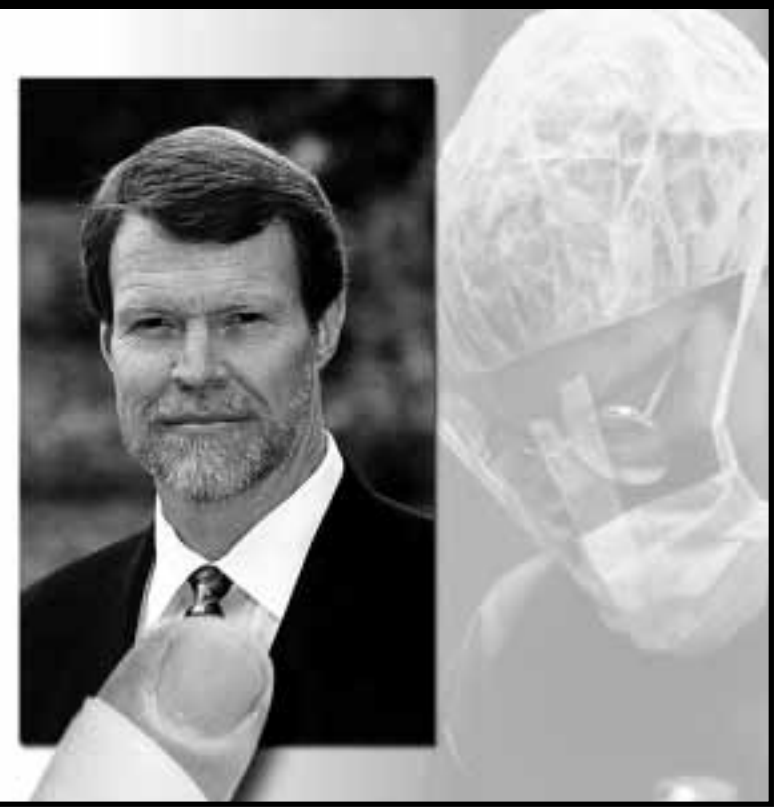

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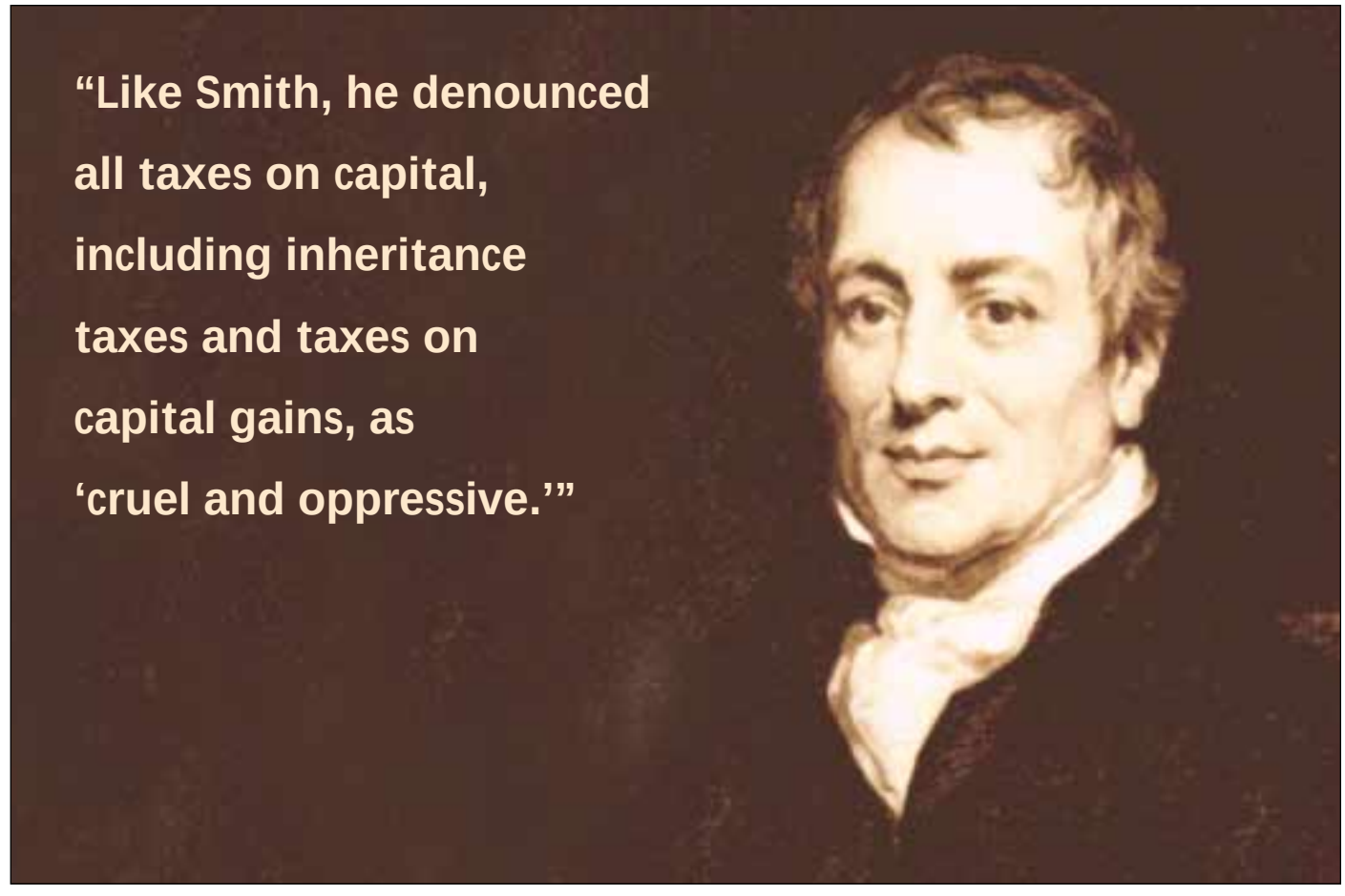
Economist David Ricardo on Taxes

by Tom Walton

David Ricardo, born in 1772, became interested in economics at the age of 27 after a chance reading of Adam Smith's *The Wealth of Nations* (1776). Ricardo did not become a full-time professional economist until he was 41—after he had amassed a fortune as a dealer in government securities.

Ricardo published the first edition of his magnum opus, *The Principles of Political Economy and Taxation*, in 1817. In 1819 he was elected to the British Parliament, where he was an outspoken opponent of trade protectionism and advocate for unfettered labor and capital markets. He served until his death in 1823, leaving an estate worth $100 million in today's dollars. But Ricardo's greatest legacy was the theorem of comparative advantage, in which he demonstrated the unambiguous and universal benefits of free trade.

Ricardo is lesser known for his theories of taxation, which closely track those of Adam Smith. However, his theory of comparative advantage, like his analysis of taxation, provides a solid foundation for modern principles of taxation, regulation, and public finance.


"Like Smith, he denounced all taxes on capital, including inheritance taxes and taxes on capital gains, as 'cruel and oppressive.'"

Ricardo's Principles of Taxation

Ricardo endorsed Smith's four tax "maxims"—equity, convenience, transparency, and efficiency. (See "Adam Smith on Taxes," *Budget & Tax News*, November 2003.) He agreed that broadly based taxes are more efficient and fair than taxes aimed at specific lines of business or imposed on specific commodities. Like Smith, he denounced all taxes on capital, including inheritance taxes and taxes on capital gains, as "cruel and oppressive."

Wrote Ricardo: "It should [never] be the policy of governments ... to lay such taxes as will inevitably fall on capital," since such taxes prevent capital from finding "its way into the hands of those who will best employ it" and "since, by so doing, they impair the funds for the maintenance of labor, and thereby diminish the future production of the country."

Ricardo agreed that taxes on rents from unimproved land provided the one exception to the principle that "broader is better." However, he summarily rejected taxes levied disproportionately on landowners because he believed such taxes violate Smith's equity maxim. Ricardo noted "landlords" often invested "many years of toil" into "the purchase of land or houses" and "it would certainly be an infringement of that principle which should ever be held sacred, the security of property, to subject [them] to unequal taxation."

Ricardo agreed that consumers, not sellers or manufacturers, ultimately and invariably pay the entire amount of any tax on commodities, though he disputed Smith's conclusion that sometimes consumers will be required to pay "a considerable overcharge." Said Ricardo: "[I]t is impossible to conceive that more can be paid by the public upon whomsoever the tax may fall. ... [I]f more is paid, Adam Smith should have stated by whom it is received ..."

Ricardo saved his sharpest criticism for his contemporary, Jean Baptiste Say, who held "that a manufacturer is not enabled to make the consumer pay the whole tax levied on his commodity, because its increased price will diminish its consumption." Ricardo responded, "Should this be the case, should the consumption be diminished, will not supply be speedily diminished? Why should the manufacturer continue in the trade if his profits are below the general level?" Ricardo did allow that in the very short term some of the tax could be borne by sellers, but he maintained sellers ultimately had to earn a competitive return and would thus withdraw from such unprofitable ventures should consumers refuse to foot the bill.

This is an important issue because many present-day advocates of increased taxes and regulation assert that taxed and regulated sellers and manufacturers will pick up the tab. By contrast, policy economists stand with Ricardo: The full amount of the tax cost—no more and no less—is passed on to consumers.

Ultimately, this is an empirical issue. Historically, the weight of the evidence had been on the side of Ricardo, supporting the notion of a full pass-through to consumers. In the 1980s, however, several economists developed models that predicted Smith's overcharges in markets where sellers had the ability to influence the price at which their products sold. Recently, Professors Timothy Beasley of the London School of Economics and Harvey Rosen of Princeton University found, consistent with Smith's theory, that in more than half the cases examined, consumers paid more than the amount of the tax—often substantially more—and that, on average, the pass-through occurs within three months. In none of the cases did consumers pay less than the tax.

Theorem of Comparative Advantage

Ricardo's greatest contribution to modern economic thought is found in three paragraphs in his *Principles*. There he demonstrates the benefits of specialization according to comparative advantage. By means of a simple example, he shows that workers in both Portugal and England benefit from trade between the two nations—even if Portugal's workers are more productive in every occupation. Ricardo proves the wages in both nations necessarily increase with free trade and by specialization in the production of those commodities in which workers are "comparatively" most productive.

Ironically, Ricardo's proof was based on a flawed labor theory of value—the same theory Karl Marx would exploit to "prove" the supposed superiority of central planning over capitalism. Modern economists, however, have demonstrated that the universal gains from trade also hold in the case of more broadly based theories of value that incorporate the contributions of other factors of production such as capital, technology, and managerial know-how. Importantly, these modern proofs do not require the existence of barriers to the free flow of labor or capital. All that is required is that there be differences between two regions in the costs of production.

It is not possible to overstate the importance of Ricardo's theorem. As Nobel Laureate Paul Samuelson observes, "This simple principle provides the unshakable basis for international trade." Indeed, empirical studies show that free trade has been a major force for increased living standards and reduced poverty throughout the world.

Summary and Conclusion

Ricardo's greatest contribution was in the field of international trade, showing the folly of tariffs and other trade restrictions. However, his insights on taxation are also highly relevant. They confirm the wisdom of Adam Smith that there is no free lunch and that consumers ultimately must foot the bill for taxes and regulations. Ricardo richly deserves his reputation as Smith's intellectual heir and one of the most brilliant and innovative economists of any age.

As one present-day economist puts it, "The modern economist, reading Ricardo's *Principles*, feels rather as a member of one of the Mount Everest expeditions would feel, if arriving at the top of the mountain, he encountered a hiker clad in T-shirt and tennis shoes." In other words, economics came very easy to Ricardo—as easy as climbing a mountain in a t-shirt and tennis shoes ... which is not very easy!

Tom Walton is an economist with General Motors in Detroit and a member of the Board of Directors of The Heartland Institute.

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